Supreme Court, U.S.
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No. _____

IN THE

Supreme Court of the United States

DEVON ENERGY CORPORATION,

Petitioner,

v.

KENNETH L. SALAZAR,
SECRETARY OF THE INTERIOR,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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May 2009

QUESTIONS PRESENTED

1. Whether a federal agency that has given its regulation a definitive interpretation must engage in notice-and-comment rulemaking pursuant to the Administrative Procedure Act to reverse that interpretation, where the initial interpretation has been followed for many years and set forth in mandatory instructions to regulated entities.

2. Whether a federal agency that changes its interpretation of its own regulation may give retroactive effect to the new interpretation.

PARTIES TO THE PROCEEDING AND RULE 29.6 DISCLOSURE

Petitioner, plaintiff below, is Devon Energy Corporation. Petitioner has no parent company, and no publicly held company owns ten percent or more of its stock.

Respondent is Kenneth L. Salazar, who is sued in his capacity as Secretary of the United States Department of the Interior. His predecessors Gale A. Norton and Dirk Kempthorne were likewise sued below in their capacities as Secretary of the Interior.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner Devon Energy Corporation ("Devon") respectfully requests that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the District of Columbia Circuit in this case.

OPINION BELOW

The opinion of the D.C. Circuit (Pet. App. 1a–23a) is reported at 551 F.3d 1030. The opinion of the United States District Court for the District of Columbia (Pet. App. 24a–40a), which was unreported, is available at 2007 WL 2422005.

JURISDICTION

The decision of the D.C. Circuit was entered on December 23, 2008. A timely petition for rehearing and rehearing *en banc* was denied on February 13, 2009. (Pet. App. 62a.) This Court's jurisdiction rests on 28 U.S.C. § 1254(1). The court of appeals had jurisdiction pursuant to 28 U.S.C. § 1291. The district court had jurisdiction pursuant to 28 U.S.C. § 1331.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Administrative Procedure Act provides in relevant part as follows:

> (b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice

thereof in accordance with law. The notice shall include—

(1) a statement of the time, place, and nature of public rule making proceedings;

(2) reference to the legal authority under which the rule is proposed; and

(3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.

Except when notice or hearing is required by statute, this subsection does not apply—

(A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or

(B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing, sections

556 and 557 of this title apply instead of this subsection.

5 U.S.C. § 553(b)–(c).

STATEMENT OF THE CASE

This case addresses a royalty dispute involving hundreds of millions of dollars and presenting a fundamental question of administrative law that has divided the courts of appeals.

Pursuant to the Minerals Leasing Act, 30 U.S.C. § 181 *et seq.* ("the Act"), the Secretary of the United States Department of the Interior ("DOI") issues and administers leases to private entities authorizing the production and sale of various minerals from federal lands, including natural gas. Under the Act, the lessee must pay "a royalty at a rate of not less than 12.5 percent in amount or value of the production removed or sold from the lease." *Id.* § 226(b)(1)(A). The regulations at issue in this case govern the calculation of such royalties.

Congress has given the Secretary the authority "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of [the Act]." *Id.* § 189. During the period relevant to this litigation, the Secretary had formally delegated his authority over royalty collection to the Director of

DOI's Minerals Management Service ("MMS").[1] The Director, in turn, had redelegated this authority to the Associate Director for Royalty Management.[2] MMS defined "authority" to mean "[t]he ability to make the final, binding decision and/or take specific action as an official representing the U.S. Government."[3] Consistent with the foregoing delegations, the relevant regulations relating to royalty issues were promulgated by MMS, and not by the DOI Secretary or Assistant Secretary. *See, e.g.*, Final Rule, Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (Jan. 15, 1988).

In 1988, MMS promulgated gas royalty valuation regulations providing that costs incurred by a lessee

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[1] Dep't of the Interior, 218 Departmental Manual 1.1 (May 26, 1983) ("The Director, Minerals Management Service, is authorized to exercise the Secretary's authority to establish a comprehensive Royalty Management System which ensures that the Government is paid timely and in full for the leasing of all mineral lands and for its contractual royalty shares, rentals, bonuses, and other fees for minerals extracted by lessees . . . ."). *Cf.* Dep't of the Interior, 218 Departmental Manual 1.1 (Aug. 29, 2002), *available at* http://206.131.241.18/app_dm/act_getfiles.cfm?relnum=3524.

[2] Minerals Mgmt. Serv., 220 Service Manual 1.5 (Aug. 29, 1991) ("[T]he authorities delegated to the Director in 218 DM 1 for managing and administering the Royalty Management Program are redelegated to the Associate Director for Royalty Management. . . . The Director retains the authority to . . . [a]pprove rules and publish in the *Federal Register*.").

[3] Minerals Mgmt. Serv., 200 Service Manual 1.4A (July 20, 1983).

in rendering its gas marketable are *not* deducted from the gross value of the gas against which royalty obligations are calculated, 30 C.F.R. §§ 206.152(i), 206.153(i) (1988), but that costs of transporting the gas *are* deducted, *id.* §§ 206.156, 206.157. (Pet. App. 4a–5a.) After establishing this so-called "marketable condition rule," MMS faced "many questions . . . on how to report and pay royalties on coalbed methane," (Pet. App. 63a), a resource that accounts for roughly 10% of total domestic natural gas reserves.

MMS referred these questions regarding coalbed methane gas to its Royalty Policy Board, which MMS "established to develop royalty program policy," and to act as a "decision making body to review, discuss, evaluate and decide policy decisions on proposals aimed at improving the [Royalty Management Program]." (C.A. App. 100.) The Board consisted of the MMS Deputy Director, the Associate Director for Royalty Management, and the Associate Director for Policy and Management Improvement. (*Id.* at 101.)

Among other questions, the Board addressed the proper treatment of the costs of dehydrating and compressing coalbed methane gas. After considering applicable legal authorities and agency precedents, the Board concluded that lessees should be allowed to deduct, as part of their transportation allowance, their dehydration and compression costs incurred downstream of the approved royalty measurement point. (*Id.* at 104–05.) The Board recommended that detailed instructions concerning these decisions be given to all affected parties. In response, the MMS Deputy Director issued two official statements containing the agency's instructions for valuing and

reporting royalties: "Coalbed Methane Valuation and Reporting Guidelines" dated December 7, 1995, and the more generally applicable "Compression Guidance" dated December 8, 1995. (Pet. App. 7a.) These guidance documents reflected the conclusion that dehydration and compression costs could be deducted from the royalty base as transportation costs. (*Id.* at 7a–8a.)

The MMS Associate Director for Royalty Management (to whom the Secretary's authority had been redelegated) subsequently sent an April 22, 1996 "Dear Operator/Payor" letter to every federal lease operator and royalty payor in the United States. (*Id.* at 63a–68a.) That letter set forth guidelines that each lessee was *required* to follow in calculating royalties. In the words of the April 22, 1996 letter, a payor "*must follow these guidelines* to ensure proper payment of royalties and correct reporting of production." (*Id.* at 63a (emphasis added).) The mandatory nature of these instructions was repeatedly emphasized throughout the document. (*See id.* at 63a–68a ("you must value," "you must add," "you must determine," "you cannot deduct," "you must ensure," "you must use," "you cannot include," "you must convert," "you cannot take," "you must report").) With respect to allowances for the costs of dehydration and compression of coalbed methane gas, the letter provided,

> You can include costs of dehydration occurring after metering at the royalty measurement point in your transportation allowance but you cannot deduct costs of

> dehydration occurring at the wellhead. You can include costs for compression occurring downstream of the royalty measurement point, to the extent the compression is necessary for transportation.

(*Id.* at 66a.)

Petitioner is a natural gas producer with leases in various parts of the country, including the Powder River Basin of Wyoming, an area with significant coalbed methane gas reserves. From the issuance of the "Dear Operator/Payor" letter on April 22, 1996 through 2003 — a period of seven years — Petitioner consistently abided by MMS's requirements regarding the treatment of dehydration and compression costs in calculating royalties due the United States. Insofar as Petitioner is aware, the same was true for the rest of the affected industry.[4]

In 2001, a royalty dispute arose between Petitioner and the State of Wyoming, which has certain audit rights because it receives a share of royalties, over whether Petitioner was entitled to deduct *any* transportation costs in calculating

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[4] A legal dispute did arise between some producers and MMS over a separate provision in the April 22, 1996 letter providing for the non-deductibility of the costs of removing excess carbon dioxide from coalbed methane gas. MMS prevailed in that litigation. *See Amoco Prod. Co.* v. *United States*, 410 F.3d 722 (D.C. Cir. 2005) (Roberts, J.), *aff'd on other grounds sub. nom. BP Am. Prod. Co.* v. *Burton*, 549 U.S. 84 (2006).

royalties. The State contended that deductible transportation costs did not commence until the point along the transportation route at which Petitioner had made its gas marketable through removal of excess carbon dioxide. Petitioner accordingly sought from MMS a determination that it was correctly calculating its royalty obligations.

MMS decided in Petitioner's favor on the issue raised by the State of Wyoming. (C.A. App. 57, 92.) However, in decisions issued in October 2003 and March 2004, the DOI Assistant Secretary ruled that Petitioner could not deduct post-royalty measurement point dehydration and compression costs as part of its transportation allowance. (Pet. App. 9a–10a.) The Assistant Secretary asserted that the guidance reflected in the April 22, 1996 letter from the MMS Associate Director for Royalty Management, which had been provided to Petitioner and all other lessees, was "based on a mistaken perception," and that the interpretations expressed therein were "errors" by "subordinate [DOI] officials" that were "inconsistent with or misinterpreted the marketable condition rule itself." (C.A. App. 54, 85.) The Assistant Secretary gave retroactive effect to his new interpretation of MMS's marketable condition rule, demanding that Petitioner recalculate its royalties "from the period beginning when Devon began paying royalties to the Minerals Management Service on the coalbed methane produced from the Federal leases . . . to the present," (*id.* at 55; Pet. App. 10a), even though Devon was required during this period to comply with the April 22, 1996 letter.

Petitioner sought judicial review in the United States District Court for the District of Columbia, arguing, *inter alia*, that MMS's reinterpretation of its regulations was invalid for failure to observe the procedural requirements of 5 U.S.C. § 553. The district court denied Petitioner's motion for summary judgment and granted Respondent's cross-motion for summary judgment. (Pet. App. 24a.) The United States Court of Appeals for the District of Columbia Circuit affirmed, concluding that although "Devon's preferred interpretation of the [marketable condition] rule is not unreasonable," (*id.* at 13a), the agency's 2003 interpretation prohibiting deduction of dehydration and compression costs was not at odds with the plain language of the regulations, (*id.* at 12a–14a). The court of appeals also rejected Petitioner's argument under 5 U.S.C. § 553, reasoning that the officials responsible for the guidance documents and the April 22, 1996 letter lacked the authority to bind MMS to the interpretations there expressed. (*Id.* at 15a–23a.)

REASONS FOR GRANTING THE PETITION

I. The Circuits Are Divided Over Whether An Agency Must Use Notice-And-Comment Procedures To Change Its Interpretation Of A Regulation.

This case poses an unsettled question concerning the requirements for rulemaking under the Administrative Procedure Act, 5 U.S.C. § 551 *et seq.* To promulgate a valid "rule," *id.* § 551(4), an agency must follow the APA's familiar notice-and-comment procedures by publishing a notice of proposed

rulemaking, providing an opportunity for comment, and issuing a "concise general statement of [the rule's] basis and purpose," *id.* § 553(b)–(c). The APA imposes this measure of procedural formality "to assure due deliberation," *Smiley* v. *Citibank (S.D.), N.A.*, 517 U.S. 735, 741 (1996), and "to assure fairness and mature consideration of rules of general application," *NLRB* v. *Wyman-Gordon Co.*, 394 U.S. 759, 764 (1969) (plurality opinion). Under the APA's judicial review provision, 5 U.S.C. § 706(2)(D), a court must set aside as unlawful any agency rule that is not the product of such notice-and-comment procedures. *See Chrysler Corp.* v. *Brown*, 441 U.S. 281, 313 (1979).

Among other exceptions to the notice-and-comment requirement, the APA provides that an agency need not observe such formality when it makes "interpretative rules." 5 U.S.C. § 553(b)(A). Distinguishing the interpretative rules that are exempt from the notice-and-comment requirement from the legislative rules[5] that are not is among the great challenges in administrative law. *See, e.g.*,

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[5] The term "legislative rules," which does not appear in the APA, refers to agency documents subject to the notice-and-comment requirement and capable of binding with the force of statutes. *See* John F. Manning, *Nonlegislative Rules*, 72 GEO. WASH. L. REV. 893, 893, 931 n.191 (2004). This Petition adopts the common practice of using the words "rule" and "regulation" interchangeably. *See Nat'l Treasury Employees Union* v. *Weise*, 100 F.3d 157, 160 (D.C. Cir. 1996).

Cmty. Nutrition Inst. v. *Young*, 818 F.2d 943, 946 (D.C. Cir. 1987) (per curiam) (collecting sources describing this distinction as "tenuous," "fuzzy," "blurred," "baffling," and "enshrouded in considerable smog").

It is settled that a purportedly interpretative rule that amends a prior legislative rule must be promulgated pursuant to notice-and-comment procedures. *See Shalala* v. *Guernsey Mem'l Hosp.*, 514 U.S. 87, 100 (1995). But when an agency promulgates a legislative rule, then issues an interpretative rule construing the legislative rule, and subsequently issues a contrary interpretative rule, the agency has also engaged in rulemaking by amending an earlier interpretative rule. *See* 5 U.S.C. § 551(5) (" 'rule making' means agency process for formulating, amending, or repealing a rule"). This scenario describes the facts of Petitioner's case, and presents the question of what requirements the APA imposes on an agency when it reinterprets its own regulations.

1. The courts of appeals are divided on the question of what procedure an agency must observe in contradicting a prior interpretative rule construing its own legislative rule. *See, e.g.*, *Paragon Health Network, Inc.* v. *Thompson*, 251 F.3d 1141, 1148 n.4 (7th Cir. 2001) (noting this split as between the D.C. Circuit and the First Circuit). The D.C. Circuit in prior decisions, along with the Third Circuit, Fifth Circuit, and Sixth Circuit, have all required notice and comment in this scenario. The First Circuit and Ninth Circuit have not.

This mature division of authority on an important issue of administrative law merits review in this Court. *See* RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 6.4, at 131 (4th ed. Supp. 2009) ("The circuit split on this issue has now increased, with more circuits choosing sides. . . . The Supreme Court should resolve this difference of opinion with respect to an important question that arises virtually every day at agencies.").

The division among the circuits can be traced to the leading case of *Paralyzed Veterans* v. *D.C. Arena L.P.*, 117 F.3d 579 (D.C. Cir. 1997). In that case, the D.C. Circuit considered a Department of Justice ("DOJ") regulation providing that wheelchair areas in facilities subject to the Americans with Disabilities Act must enjoy "lines of sight comparable to those for members of the general public." *Id.* at 580–81. The litigants disputed whether the regulation obliged a stadium owner to account for standing spectators in providing such lines of sight. The agency's interpretation of its own legislative rule had changed over time: A DOJ official said in a 1992 speech that the regulation did not require any attention to standing spectators, but a DOJ technical manual issued in 1994 was to the contrary. *Id.* at 581–82.

Addressing the question whether DOJ should have used notice-and-comment procedures to promulgate the manual, the D.C. Circuit agreed that "[o]nce an agency gives its regulation an interpretation, it can only change that interpretation as it would formally modify the regulation itself: through the process of notice and comment

rulemaking." *Id.* at 586. Having announced this "one bite at the interpretational apple" standard, PETER L. STRAUSS ET AL., GELLHORN AND BYSE'S ADMINISTRATIVE LAW 716 (10th ed. rev. 2003), the *Paralyzed Veterans* court declined to invalidate the DOJ manual because the speech by a mid-level official did not reflect a definitive agency interpretation of its regulation, 117 F.3d at 587.

The D.C. Circuit first used the *Paralyzed Veterans* principle to set aside an agency rule in *Alaska Professional Hunters Ass'n* v. *FAA*, 177 F.3d 1030 (D.C. Cir. 1999). A legislative rule of the FAA required "commercial operator[s]" of airplanes to abide by certain safety standards. *Id.* at 1031–32. Alaskan hunting guides challenged an FAA Notice to Operators, promulgated without notice and comment, compelling the guides for the first time in decades to follow the "commercial operator" safety standards when using small aircraft to transport customers. *Id.*

The D.C. Circuit found that the Notice's interpretation of the legislative rule contradicted the FAA's prior interpretation, as embodied in thirty-five years of consistent but unwritten advice from the FAA's Alaska Region to the regulated hunting guides that they were not "commercial operator[s]." *Id.* at 1033–35. Accordingly, the court set aside the Notice under *Paralyzed Veterans* due to the FAA's failure to use notice-and-comment procedures. *Id.* at 1036. The *Alaska Professional Hunters* court restated the *Paralyzed Veterans* principle as follows: "When an agency has given its regulation a definitive interpretation, and later significantly revises that

interpretation, the agency has in effect amended its rule, something it may not accomplish without notice and comment." *Id.* at 1034.

The D.C. Circuit's *Paralyzed Veterans* principle has been embraced by other courts of appeals. The Third Circuit recognizes that "if an agency's present interpretation of a regulation is a fundamental modification of a previous interpretation, the modification can only be made in accordance with the notice and comment requirements of the APA." *SBC Inc.* v. *FCC*, 414 F.3d 486, 498 (3d Cir. 2005) (citing *Paralyzed Veterans*). The Fifth Circuit "agree[s] with the reasoning of the D.C. Circuit [and holds that] the APA requires an agency to provide an opportunity for notice and comment before substantially altering a well established regulatory interpretation." *Shell Offshore Inc.* v. *Babbitt*, 238 F.3d 622, 629 (5th Cir. 2001) (citing *Paralyzed Veterans* and *Alaska Professional Hunters*). The Sixth Circuit likewise concludes "that once an agency gives a *regulation* an interpretation, notice and comment will often be required before the interpretation of that regulation can be changed." *Dismas Charities, Inc.* v. *DOJ*, 401 F.3d 666, 682 (6th Cir. 2005) (citing *Alaska Professional Hunters*).

The First Circuit and the Ninth Circuit, on the other hand, have rejected the *Paralyzed Veterans* principle. *See Warder* v. *Shalala*, 149 F.3d 73, 81–82 (1st Cir. 1998); *Erringer* v. *Thompson*, 371 F.3d 625, 632 (9th Cir. 2004) ("[N]o notice and comment rulemaking is required to amend a previous *interpretive* rule."); *Chief Probation Officers* v. *Shalala*, 118 F.3d 1327, 1337 (9th Cir. 1997) (White,

Retired Justice, sitting by designation) ("If an agency maintains that a rule, not held out as having the force of law, is mandated by statute, it will be legislative . . . only if it is inconsistent with an existing regulation. In other words, the rule would have to be inconsistent with another rule having the force of law, not just any agency interpretation regardless of whether it had been codified.") (citation omitted).

In addition to the attention it has received in the courts of appeals, the *Paralyzed Veterans* principle has garnered favorable mention from members of this Court. Justice Stevens, in a dissent joined by Justices Souter, Thomas, and Ginsburg, has referenced "the APA's requirement of new rulemaking when an agency substantially modifies its interpretation of a regulation." *Geier* v. *Am. Honda Motor Co.*, 529 U.S. 861, 912 (2000) (Stevens, J., dissenting) (citing *Paralyzed Veterans*). Justice Alito, writing for the Third Circuit as a member of that court, applied the *Paralyzed Veterans* principle in vacating an agency's rule. *Caruso* v. *Blockbuster-Sony Music Entm't Ctr.*, 174 F.3d 166, 175–77 (3d Cir. 1999) (citing *Paralyzed Veterans*), *vacated*, 193 F.3d 730 (3d Cir. 1999). This important issue of administrative law, which has divided the courts of appeals, is now worthy of the full Court's attention.

2. In applying its circuit-splitting *Paralyzed Veterans* principle to the facts of Petitioner's case, the D.C. Circuit has created a further division among those courts that recognize the principle. The decision below squarely conflicts with *Shell Offshore Inc.* v. *Babbitt*, 238 F.3d 622 (5th Cir. 2001), another

case involving MMS's contradictory interpretations of its royalty-calculation regulations. The result is a three-way split between circuits that reject the *Paralyzed Veterans* principle, circuits that apply the principle narrowly, and circuits that apply it broadly.

The D.C. Circuit continues to employ the *Paralyzed Veterans* principle when agencies reinterpret their own legislative rules without using notice-and-comment procedures. *See, e.g.*, *MetWest Inc.* v. *Sec'y of Labor*, 560 F.3d 506, 509–11 (D.C. Cir. 2009); *Envtl. Integrity Project* v. *EPA*, 425 F.3d 992, 997–98 (D.C. Cir. 2005). But the D.C. Circuit has now diverged from a sister circuit in its application of the principle. The decision below held that MMS was not required to use notice and comment to promulgate its 2003 interpretation of the market condition rule because the contrary interpretation reflected in various guidance documents, as well as the agency's consistent practice over a seven-year period, purportedly did not constitute a binding agency interpretation.[6]

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[6] (*See* Pet. App. 17a–20a (citing *Amoco Prod. Co.* v. *Watson*, 410 F.3d 722, 725 (D.C. Cir. 2005) (Roberts, J.), and *Indep. Petroleum Ass'n* v. *Babbitt*, 92 F.3d 1248, 1256–57 (D.C. Cir. 1996), for the proposition that the MMS documents at issue in this case did not bind the agency).) The delegations of authority previously described, *supra* at 3–4, were not discussed in *Amoco* or *Independent Petroleum*, presumably because they were not raised by the parties in those cases.

The Fifth Circuit reached the opposite conclusion in *Shell*, on facts less favorable to the regulated entity. *Shell* involved an MMS regulation providing that an "approved" FERC tariff could be used as the cost of transporting crude oil for purposes of calculating royalty payments due the United States. For five years, MMS had followed an unwritten but consistent practice of treating tariffs filed with FERC as having been approved by FERC, and thus allowable for purposes of royalty calculations, regardless whether FERC had affirmatively approved the tariff. 238 F. 3d at 624–26. MMS then purported to change its interpretation to require affirmative FERC approval. *Id.* at 628–29.

Relying on *Alaska Professional Hunters* and *Paralyzed Veterans*, the Fifth Circuit held that MMS was obliged to use notice-and-comment procedures in promulgating its amended interpretation. *Id.* at 629–30; *see also Torch Operating Co.* v. *Babbitt*, 172 F. Supp. 2d 113, 124–28 (D.D.C. 2001) (following *Shell* in a factually similar case).

The conflict between the D.C. Circuit and the Fifth Circuit is clear. The Fifth Circuit held that a five-year period of MMS practice, unaccompanied by any written guidance from the agency, was sufficiently authoritative to warrant notice-and-comment procedures under *Paralyzed Veterans*. *Shell*, 238 F.3d at 628–29 ("[T]he new 'rule' that Shell asserts violates the APA is not a change from a written policy statement or regulation. Rather, it is an alteration of an existing practice."). The D.C. Circuit, by contrast, held that a seven-year period of MMS practice, even when combined with written

pronouncements by agency officials, was not authoritative and therefore did not demand notice-and-comment procedures under *Paralyzed Veterans*. (Pet. App. 17a–20a.).

One might expect the opposite result in this pair of cases — if the facts of *Shell* support notice-and-comment rulemaking, Petitioner's facts should make for an even stronger case under *Alaska Professional Hunters* and *Paralyzed Veterans*. In addition to the seven-year period of consistent agency practice, Petitioner could also point to written agency instructions couched in unmistakably mandatory language. *Cf. Gen. Elec. Co.* v. *EPA*, 290 F.3d 377, 384 (D.C. Cir. 2002) ("To the applicant reading the Guidance Document the message is clear: in reviewing applications the Agency will not be open to considering approaches other than those prescribed in the Document."); *Appalachian Power Co.* v. *EPA*, 208 F.3d 1015, 1023 (D.C. Cir. 2000) ("[T]he entire Guidance, from beginning to end — except the last paragraph — reads like a ukase. It commands, it requires, it orders, it dictates."); *United States* v. *Chrysler Corp.*, 158 F.3d 1350, 1356 (D.C. Cir. 1998) ("[A]n agency is hard pressed to show fair notice when the agency itself has taken action in the past that conflicts with its current interpretation of a regulation."). It appears MMS's procedural obligations under the APA vary according to the forum in which judicial review is sought.

Juxtaposition of *Shell* with the decision below shows that the D.C. Circuit has aggravated the *Paralyzed Veterans* controversy into a three-way circuit split. In some circuits, like the First Circuit

and the Ninth Circuit, an agency is always at liberty to reinterpret its legislative rules without notice and comment. In the D.C. Circuit, the agency's interpretive freedom depends on the authorship of its written interpretations. Meanwhile, in the Fifth Circuit, an agency is bound by the interpretations reflected in its consistent practice, regardless whether such interpretations have been reduced to written form.

* * *

As shown above, the courts of appeals are divided on whether the *Paralyzed Veterans* principle is good law and, if so, on how to employ it when an agency takes more than one bite at the interpretational apple. Such a division of authority leaves agencies uncertain about the necessary level of procedural formality, and deprives regulated parties of information about applicable regulations that they might otherwise use in structuring their affairs. The conflicting decisions of the courts of appeals on this important question of administrative law can only be harmonized by a decision from this Court.

II. Retroactive Application Of The Agency's Changed Interpretation Of Its Regulation Cannot Be Reconciled With This Court's Precedent.

The court of appeals upheld an MMS rule "requiring Devon *retroactively* to recalculate royalties owed to the Government." (Pet. App. 2a (emphasis added).) In so doing, the decision below ran afoul of the strong anti-retroactivity principle reflected in the

decisions of this Court. Review is warranted to address this departure from precedent.

"Retroactivity is not favored in the law," and so in the absence of express statutory authorization, an administrative agency lacks the power to engage in retroactive rulemaking. *Bowen* v. *Georgetown Univ. Hosp.*, 488 U.S. 204, 208 (1988). The presumption against retroactive legislation, by Congress and by the agencies to which it delegates authority, has constitutional underpinnings and a long pedigree. *See, e.g.*, *Landgraf* v. *USI Film Prods.*, 511 U.S. 244, 266, 286 (1994) (describing expression of the "presumption against statutory retroactivity" in the Constitution's Ex Post Facto, Contracts, Takings, Attainder, and Due Process Clauses); *Kaiser Aluminum & Chem. Corp.* v. *Bonjorno*, 494 U.S. 827, 855 (1990) (Scalia, J., concurring) ("The principle that the legal effect of conduct should ordinarily be assessed under the law that existed when the conduct took place has timeless and universal human appeal."). The APA lends further support to the presumption against retroactivity in the administrative law context. *See Bowen*, 488 U.S. at 224 (Scalia, J., concurring).

In this case, MMS gave its regulations a new interpretation in 2003 and compelled Petitioner to recalculate previously incurred royalties, which had already been calculated in accordance with the agency's existing interpretation. (Pet. App. 10a; C.A. App. 55.) At the time Petitioner incurred its royalty obligations, MMS allowed lessees to deduct certain compression and dehydration costs from the royalty base for coalbed methane gas. MMS turned back the

clock and demanded additional payment based on a royalty base from which compression and dehydration costs had not been deducted.

This case thus poses the question identified but left unresolved in *Smiley* v. *Citibank (S.D.), N.A.*, 517 U.S. 735, 744 n.3 (1996). In *Smiley*, a case involving deference to an agency's interpretation of a statute under *Chevron U.S.A., Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), a party argued "that deferring to the regulation in this case involving antecedent transactions would make the regulation retroactive, in violation of [*Bowen*]." *Smiley*, 517 U.S. at 744 n.3.

This Court rejected the argument because there had been no agency guidance as to the meaning of the statute when the regulated conduct occurred. *Id.* ("Where . . . a court is addressing transactions that occurred at a time when there was no clear agency guidance, it would be absurd to ignore the agency's current authoritative pronouncement of what the statute means."). The Court noted, however, that *Bowen*'s presumption against retroactivity might have been in play had the agency announced a contrary interpretation contemporaneous with the regulated conduct. *Id.* ("There might be substance to this point if the regulation replaced a prior agency interpretation — which, as we have discussed, it did not."). *See also Long Island Care at Home, Ltd.* v. *Coke*, 551 U.S. 158, 127 S. Ct. 2339, 2349 (2007) ("[W]e concede that the Department may have interpreted these regulations differently at different times in their history. . . . But as long as interpretive changes create no unfair surprise — and the

Department's recourse to notice-and-comment rulemaking in an attempt to codify its new interpretation . . . makes any such surprise unlikely here — the change in interpretation alone presents no separate ground for disregarding the Department's present interpretation.") (citing *Bowen*, 488 U.S. at 212).

MMS's attempt to rewrite the rules after the game has ended presents the scenario described in *Smiley*. Although Petitioner complained of retroactivity in the questions presented in its appellate brief, the court of appeals did not address the problem of administrative retroactivity, and the decision below failed to account for Petitioner's justifiable reliance on the agency's interpretation of its own regulation. *See Landgraf*, 511 U.S. at 265 ("Elementary considerations of fairness dictate that individuals should have an opportunity to know what the law is and to conform their conduct accordingly; settled expectations should not be lightly disrupted."); *cf. FCC* v. *Fox Television Stations, Inc.*, No. 07-582, slip op. at 11–12 (U.S. Apr. 28, 2009) (noting that an agency must "provide a more detailed justification . . . when its prior policy has engendered serious reliance interests that must be taken into account").

The decision below was thus at odds with this Court's retroactivity precedent, and review is warranted for this reason. "The largest category of cases in which we have applied the presumption against statutory retroactivity has involved new provisions affecting contractual or property rights, matters in which predictability and stability are of

prime importance." *Landgraf*, 511 U.S. at 271. That is precisely the case here.

CONCLUSION

The petition for a writ of certiorari should be granted.

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No. _____

IN THE
Supreme Court of the United States

DEVON ENERGY CORPORATION,

Petitioner,

v.

KENNETH L. SALAZAR,
SECRETARY OF THE INTERIOR,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

APPENDICES TO PETITION FOR A WRIT OF CERTIORARI

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Argued September 15, 2008 Decided December 23, 2008

No. 07-5299

DEVON ENERGY CORPORATION,
APPELLANT

v.

DIRK KEMPTHORNE, SECRETARY OF THE INTERIOR,
APPELLEE

Appeal from the United States District Court
for the District of Columbia
(No. 04cv00821)

Deborah B. Haglund argued the cause for appellant. With her on the briefs was *Charles D. Tetrault*.

Erik Milito and *Michele Schoeppe* were on the brief for *amicus curiae* American Petroleum Institute in support of appellant.

Sambhav N. Sankar, Attorney, U.S. Department of Justice, argued the cause for appellee. With him on the brief was *Michael T. Gray*, Attorney. *R. Craig Lawrence*, Assistant U.S. Attorney, entered an appearance.

Before: BROWN, *Circuit Judge*, and EDWARDS and SILBERMAN, *Senior Circuit Judges*.

Opinion for the Court filed by *Senior Circuit Judge* EDWARDS.

EDWARDS, *Senior Circuit Judge*: The United States leases the rights to extract and sell natural

gas from lands owned by the Government. In exchange, lessees, like appellant Devon Energy Corporation ("Devon"), agree to pay the United States royalties on the natural gas they are able to produce. This case arises from a final order issued by the United States Department of the Interior ("DOI" or "Interior") requiring Devon retroactively to recalculate royalties owed to the Government pursuant to its lease to extract coalbed methane from federal land in Wyoming.

At issue is the agency's interpretation of its "marketable condition rule." The rule was included as a part of DOI's 1988 Revision of Gas Royalty Valuation Regulations, which establish the framework for calculating the royalty value of coalbed methane gas production. In its disputed order, DOI held that the marketable condition rule precluded Devon from deducting certain costs associated with compression and dehydration when calculating the "gross proceeds" upon which royalties are owed. DOI determined that gas cannot enter a pipeline and move to a purchaser unless it meets the requirements of the pipeline, which typically requires compression to raise its pressure and dehydration to reduce its water content. Thus, DOI concluded that if gas is not sufficiently compressed and dehydrated to be deliverable to the point of purchase through the pipeline, it is not in marketable condition. Devon filed suit in the District Court to challenge Interior's order. The District Court denied Devon's motion for summary judgment and granted the Secretary's cross-motion. On appeal, Devon argues that DOI's order is inconsistent with the plain language of the

marketable condition rule, and also inconsistent with DOI's own prior interpretation of the rule.

We affirm the judgment of the District Court. First, we find that Interior's interpretation of the marketable condition rule reflects a perfectly reasonable construction of the rule. It is clear that the agency's order is not at odds with the plain language of the rule, nor does it effectively "amend," rather than reasonably construe, the rule. Second, we reject Devon's claim that DOI's order conflicts with a prior interpretation of the marketable condition rule. Devon argues that its position finds support in guidance documents distributed by agency personnel after DOI's promulgation of the 1988 regulations. However, as Devon concedes, these contested guidance documents were distributed by agency individuals who had no authority either to amend the marketable condition rule or to issue authoritative guidelines on behalf of the agency.

I. BACKGROUND

A. *Statutory and Regulatory Framework*

Through its Minerals Management Service ("MMS"), Interior issues and administers leases authorizing the removal of natural gas from federal land. The Mineral Leasing Act, 30 U.S.C. §§ 181 *et seq.* (2000), "was intended to promote wise development of these natural resources and to obtain for the public a reasonable financial return on assets that 'belong' to the public." *California Co. v. Udall*, 296 F.2d 384, 388 (D.C. Cir. 1961). Under the Mineral Leasing Act, the producer-lessees must pay the government-lessor "a royalty at a rate of not less than 12.5 percent in amount or value of the

production removed or sold from the lease." 30 U.S.C. § 226(b)(1)(A). In the Federal Oil and Gas Royalty Management Act, the Secretary of the Interior was instructed by Congress to create a comprehensive inspection, collection, accounting, and auditing system to ensure that the government receives the royalties owed. 30 U.S.C. § 1711(a) (1982).

The Mineral Leasing Act gives DOI the authority "to prescribe necessary and proper rules and regulations and to do any and all things necessary to carry out and accomplish the purposes of" the Act. 30 U.S.C. § 189. Pursuant to this directive, DOI has issued a number of regulations governing the royalty valuation process. In 1988, DOI conducted a major rulemaking that modified the then-existing gas royalty valuation regulations. *See* Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230, 1272 (Jan. 15, 1988); 30 C.F.R. § 206.152 (1988). The 1988 regulations establish the framework for calculating the royalty value of the coalbed methane gas production at issue here. Under this regulatory framework, royalties are calculated on the basis of the total value a lessee receives for its production. The regulations specify that the "value of production" should be no less "than the gross proceeds accruing to the lessee for lease production," minus certain allowable deductions. 30 C.F.R. § 206.152(h); *see also Amoco Prod. Co. v. Watson*, 410 F.3d 722, 725 (D.C. Cir. 2005), *aff'd sub nom., BP Am. Prod. Co. v. Burton*, 549 U.S. 84 (2006).

When calculating "gross proceeds," DOI regulations have long interpreted the Mineral Leasing Act to require lessees to put the gas into marketable condition at no cost to the United States

– the so-called "marketable condition rule." The 1988 regulations confirmed this requirement. *See* 30 C.F.R. § 206.152(i) (governing unprocessed gas); 30 C.F.R. § 206.153(i) (governing processed gas); *see also California Co.*, 296 F.2d at 387-88 (affirming marketable condition requirement). Marketable condition is defined in the DOI regulations as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.151. If a lessee sells "unmarketable" gas at a lower price, the gross proceeds are "increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services" to place the gas in marketable condition. 30 C.F.R. § 206.152(i); *Amoco*, 410 F.3d at 725-26.

The 1988 regulations also provide that the lessee may deduct its actual costs of transporting the gas from the wellhead to the point of sale when gas produced from the lease is sold at a market remote from the lease. 30 C.F.R. § 206.157(a)-(b). This "transportation allowance" includes "only those costs which are directly related to the transportation of lease production." 53 Fed. Reg. at 1261. A transportation allowance is defined as "an allowance for the reasonable, actual costs of moving [gas] to a point of sale or delivery off the lease . . . or away from a processing plant." 30 C.F.R. § 206.151.

B. *Facts and Proceedings Below*

Devon leases land from the United States in Wyoming's Powder River Basin, which contains the natural gas known as coalbed methane. These leases cover three fields – Kitty, Spotted Horse, and Rough

Draw – each of which contains a large number of individual gas-producing wells. The gas produced from the wells is gathered at central delivery points ("CDPs") that have been approved by the Bureau of Land Management as the points of measure for the royalty due on the gas. After the gas leaves a CDP, it goes through a complex series of compression and dehydration processes as it travels "downstream" to the Buckshot processing plant in preparation for eventual sale. *See* Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, *reprinted in* Joint Appendix ("J.A.") 57 ("Valuation Determination"); *see also* Chart, J.A. 460.

The production process varies slightly in the three fields, but the differences are not material. Essentially, each CDP is connected to a small diameter pipeline. Gas travels from the CDP through the pipeline to one of several "screw compressors," which compress the gas to raise its pressure. The gas then travels through the pipeline to a "field booster," a reciprocating compressor that further raises the pressure of the gas. The gas then enters a dehydrator, which removes water. Valuation Determination, J.A. 61. At this point, the gas enters a 24-inch high-pressure gas pipeline, which begins at what is known as the Landeck Station and runs 126 miles to the Buckshot Gas Plant. Approximately 30 miles from the Landeck Station, the gas enters a large compressor called the "MTG Booster," which compresses the gas to raise the pressure from 450-500 pounds per square inch ("psi") to approximately 1,200 psi. The gas travels the remaining 96 miles to the Buckshot Gas Plant,

losing approximately one-third of its pressure on the way. *Id.* at 66.

When the gas arrives at the Buckshot Gas Plant, excess carbon dioxide is removed, the gas is dehydrated, and the gas is compressed from approximately 800 psi to 1,100 psi. At that pressure, Devon delivers the treated gas into one of two lateral pipelines. The gas is transported to various purchasers through these pipelines. *Id.*

On November 2, 1995, DOI and MMS personnel serving on a group called the Royalty Policy Board met to discuss how the royalty calculation regulations should be applied to coalbed methane production. *See* Royalty Policy Board Meeting Minutes, Nov. 2, 1995, *reprinted in* J.A. 102. Subsequently, on December 7, 1995, and December 8, 1995, the then-Deputy Director of MMS issued two documents captioned "Coalbed Methane Valuation and Reporting Guidelines" and "Compression Guidance," respectively. *See* Coalbed Methane Valuation and Reporting Guidelines, Dec. 7, 1995, *reprinted in* J.A. 157; Compression Guidance, Dec. 8, 1995, *reprinted in* J.A. 160 [hereinafter, along with the "Dear Operator" letter, *infra*, "guidance documents"]. These documents were memoranda from the Deputy Director to the Associate Director for Royalty Management and the Associate Director for Policy and Management Improvement. J.A. 83. Although they were not promulgated pursuant to the notice-and-comment procedures of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553 (2000), the guidance documents nonetheless suggested that certain costs of compression and

dehydration after the gas leaves the CDP were deductible as transportation costs.

Subsequently, on April 22, 1996, MMS's Associate Director for Royalty Management distributed a "Dear Operator" letter detailing how to calculate royalties on coalbed methane production. The letter stated:

> If you sell your coalbed methane at the tailgate of a carbon dioxide removal or other treating facility . . . [y]ou can include costs of dehydration occurring after metering at the royalty measurement point in your transportation allowance but you cannot deduct costs of dehydration occurring at the wellhead. You can include costs for compression occurring downstream of the royalty measurement point, to the extent the compression is necessary for transportation. This includes compression at the CDP and in the transportation system to the [carbon dioxide] removal facility.

MMS Dear Operator Letter, Apr. 22, 1996, *reprinted in* J.A. 162, 164 [hereinafter, along with the "Coalbed Methane Valuation and Reporting Guidelines" and the "Compression Guidance," *supra*, "guidance documents"].

From 1995 to 2002, Devon deducted the following costs as transportation allowances: the cost of compressing the gas at the screw compressors, the field boosters, the MTG Booster, and the Buckshot Gas Plant, as well as the cost of dehydrating the gas. Devon apparently assumed that these expenses were deductible transportation costs under the guidance documents. On January 11, 2002, however, Devon sought guidance from MMS to confirm that it was

properly deducting (as part of its transportation allowance) dehydration and compression costs incurred after the gas leaves the CDPs. Request for Valuation Determination, Jan. 11, 2003, *reprinted in* J.A. 166. On October 9, 2003, the Acting Assistant Secretary issued a decision rejecting Devon's reliance on the guidance documents. *See* Valuation Determination, J.A. 57.

In its Valuation Determination, the agency found that statements in the guidance documents were either ambiguous, J.A. 84-85, or reflected an incorrect application of the marketable condition rule, J.A. 84, or were simply "inconsistent" with the rule, J.A. 85. The DOI Valuation Determination held that Devon's deductions of the costs of dehydration and of compression performed at the screw compressors, the reciprocating compressors, and the Buckshot Plant were inconsistent with the marketable condition rule, because the compression and dehydration functions were necessary to put the production into marketable condition.

> Devon could not meet the requirements of any of its sales contracts without compressing the gas to the pressure necessary to get it into those [pipe]lines . . . . That is the pressure that would enable the gas to be "accepted by a purchaser under a sales contract typical for the field or area," in the words of the definition [of the marketable condition rule] at 30 C.F.R. § 206.151. In other words, to meet the requirements of the "sales contract[s] typical for the field or area," Devon had to compress the gas to pipeline pressure.

Id. at 88.

> Both before and after the 1988 regulations, the lessee's obligation is to dehydrate gas to the water content required for delivery to the pipeline (as necessary for sale under contracts that are typical for the disposition of gas produced from the field or area). . . .
>
> Devon has not shown that the dehydration performed after the reciprocating compressors and at the Buckshot Plant is for anything other than what is required to put the production into marketable condition and what is necessary for it to meet pipeline and purchaser requirements.

Id. at 91.

Devon's request for reconsideration of the DOI Valuation Determination was denied in March 2004. Final Order to Perform Restructured Accounting and Pay Additional Royalties ("Final Order"), Mar. 19, 2004, *reprinted in* J.A. 46. The DOI Final Order largely reaffirmed the reasoning and conclusions reached in the DOI Valuation Determination. Devon was instructed to "perform a restructured accounting and pay additional royalties on the coalbed methane produced from the Federal leases" that were the subject of the DOI Valuation Determination. J.A. 55. Devon was also instructed that, in the future, it was to "report and pay royalties under the regulations and guidelines discussed" in the DOI Final Order. *Id.*

Devon filed suit in the District Court seeking to overturn the Final Order. The District Court denied Devon's motion for summary judgment and granted Interior's cross-motion for summary judgment. *Devon Energy Corp. v. Norton*, No 04-Civ-0821, 2007

WL 2422005 (D.D.C. Aug. 23, 2007). This appeal followed.

II. Analysis

A. *Standard of Review*

"In a case like the instant one, in which the District Court reviewed an agency action under the APA [5 U.S.C. § 706], we review the administrative action directly, according no particular deference to the judgment of the District Court." *Holland v. Nat'l Mining Ass'n*, 309 F.3d 808, 814 (D.C. Cir. 2002); *see also Troy Corp. v. Browner*, 120 F.3d 277, 281 (D.C. Cir. 1997); *Gas Appliance Mfrs. Ass'n, Inc. v. Dep't of Energy*, 998 F.2d 1041, 1045 (D.C. Cir. 1993). We will uphold the contested agency action unless we find it to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A).

An agency's interpretation of its own regulation is entitled to "substantial deference," unless "plainly erroneous or inconsistent with the regulation." *Thomas Jefferson Univ. v. Shalala*, 512 U.S. 504, 512 (1994) (internal quotation marks omitted). However, an agency may not "evade [the] notice and comment requirements [of § 553 of the APA, 5 U.S.C. § 553(b)(A),] by amending a rule under the guise of reinterpreting it." *Envtl. Integrity Project v. EPA*, 425 F.3d 992, 995 (D.C. Cir. 2006) (quoting *Molycorp, Inc. v. EPA*, 197 F.3d 543, 546 (D.C. Cir. 1999)); *see also Am. Hosp. Ass'n v. Bowen*, 834 F.2d 1037, 1044-48, 1052-57 (D.C. Cir. 1987). In determining whether an agency action effectively "amends" a rule without adhering to the requirements of the APA, we must consider, *inter alia*, whether the agency

officials involved in the disputed actions had the authority to issue binding regulations or otherwise act with the force of law on behalf of the agency. *See generally* HARRY T. EDWARDS & LINDA A. ELLIOTT, FEDERAL STANDARDS OF REVIEW – REVIEW OF DISTRICT COURT DECISIONS AND AGENCY ACTIONS 130-35 (2007).

B. *Plain Language*

Under the 1988 DOI regulations, "marketable condition" is defined to mean "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.151. The marketable condition rule requires lessees to put gas into marketable condition at no cost to the United States. At issue here is DOI's interpretation of the rule to include the costs of compression and dehydration incurred after the gas leaves the CDPs to allow it to move through the pipelines that serve the market in which the gas is typically sold. Devon argues that this interpretation is inconsistent with the plain language of the regulations, because it improperly focuses the inquiry on the market where the gas is actually sold, as opposed to the requirements of a sales contract typical for the field or area.

In its Valuation Determination and Final Order, DOI held that costs associated with compression and dehydration are not deductible if their primary function is to prepare the gas to move through the pipelines to the point where gas is purchased. However, the parties disagree as to what "sales contract typical for the field or area" requires. DOI found that "typical" sales contracts require that gas be delivered to the purchaser at the terminus of a

specified pipeline. Under this view, a producer must provide the compression and dehydration necessary to allow the gas to be delivered through the pipeline. Therefore, the agency reasonably found that Devon "could not meet the requirements of any of its sales contracts without compressing the gas to the pressure necessary to get it into" the pipelines, J.A. 88, and that Devon had "not shown that the dehydration performed . . . [was] for anything other than what is required to put the production into marketable condition . . . to meet pipeline and purchaser requirements." J.A. 91.

It is true that the DOI marketable condition rule is ambiguous, and Devon's preferred interpretation of the rule is not unreasonable. In other words, we assume that the costs of dehydration and compression can reasonably be interpreted to fall within the compass of "transportation costs." However, we are obliged to afford "substantial deference to an agency's interpretation of its own regulations." *Thomas Jefferson Univ.*, 512 U.S. at 512 (citations omitted). On this record, we find that DOI's contested construction of the marketable condition rule is reasonable. Indeed, DOI's interpretation of the marketable condition rule is consistent with an interpretation that this court approved in *Amoco*, 410 F.3d 722.

In *Amoco*, we addressed DOI's interpretation of the marketable condition rule as it related to the cost of transporting excess carbon dioxide to the treatment plant. The court held that the marketable condition rule did not require DOI to "understand typical sales contracts – and thus marketable condition – as relating to transactions at the

leasehold or immediately nearby." *Id.* at 729. "The regulation stipulating that producers are to place gas in marketable condition at no cost to the government does not contain a geographic limit." *Id.* Therefore, DOI's interpretation of the marketable condition rule to require lessees to compress and dehydrate gas to meet the requirements of the pipelines that serve its typical purchasers is not "plainly erroneous or inconsistent with the regulation." *Thomas Jefferson Univ.*, 512 U.S. at 512. And as the court noted in *Amoco*, the deference that we owe to an agency's interpretation of its own regulations "is particularly appropriate in the context of a complex and highly technical regulatory program, in which the identification and classification of relevant criteria necessarily require significant expertise and entail the exercise of judgment grounded in policy concerns." 410 F.3d at 729 (citations and quotations omitted).

C. ***The Requirements of a Typical Sales Contract***

Devon argues that there is no record support for the agency's conclusion that the typical sales contract for the field or area required Devon to compress its gas to 1,100 psi and dehydrate it in order to put the gas in marketable condition. However, although DOI provided Devon an opportunity to supplement the record after the first valuation determination, Devon merely asserted that it "believes that its working interest partner, Redstone Resources, Inc., sells gas to unrelated third parties in the field at pressures less than 1200 psi [sic] under contracts typical for the field or area." Request for Reconsideration and/or Clarification, *reprinted in* J.A. 194, 196. This cursory assertion is

not sufficient to render DOI's interpretation unreasonable.

D. *Prior Inconsistent Interpretation*

Finally, Devon argues that the agency's interpretation of the marketable condition rule (embodied in the DOI Valuation Determination and Final Order) must be vacated because it was issued without notice-and-comment rulemaking required by § 553 of the APA. At bottom, Devon's central claim is that it acted in reliance on the guidance documents and this "reliance interest is protected by the APA." Appellant's Br. at 16. Devon's argument runs as follows:

> The marketable condition rule does not prohibit the deduction of transportation costs, and it does not attempt to differentiate between deductible transportation costs and nondeductible marketable condition costs. Because the regulations do not expressly address the issue, the Royalty Policy Board was called upon to interpret the regulations. [*Id.*]
>
> [The Board's] decision gave rise to [the guidance documents] which were consistently followed by Interior from 1995 until 2003. [*Id.*]
>
> Devon followed Interior's publicly-announced guidelines and instructions when it deducted its post-CDP dehydration and compression costs. [*Id.*]
>
> Interior's decision in this case wrongly assumes that Interior was not bound by its 1995 guidelines and instructions because they were not embodied in a formal regulation. This Court has long recognized that an agency interpretation can be

> authoritatively adopted even if it was not embodied in a rule that was adopted through a notice and comment rulemaking. [*Id.* at 17.]
>
> An agency's consistent advice – and here it was instruction – to the regulated community can evidence the agency's authoritative adoption of a regulatory interpretation. Such an interpretation can be changed only through a notice and comment rulemaking. [*Id.*]

DOI's description of the situation is quite different. According to the agency, there was no official or binding Royalty Policy Board action taken to address the issues now before the court. Rather, DOI contends that

> [n]otice and comment rulemaking was . . . not required for Interior to change its interpretation of its regulation from how it had been applied as a result of ambiguous guidance documents. This Court has held that the very same guidance documents were not binding on the agency. [*See Amoco*, 410 F.3d at 732.] If they were not binding, then they are not evidence of a definitive agency interpretation and Interior can change its interpretation without going through notice and comment rulemaking. . . . Absent a definitive interpretation, the APA does not require notice and comment rulemaking to effect a change in that interpretation.

Appellee's Br. at 15-16. For the reasons stated below, we agree with DOI.

First, it is telling that the agency's disputed Valuation Determination and Final Order came only after Devon sought confirmation from the agency

that it was properly deducting the dehydration and compression costs (as part of its transportation allowance) incurred after the gas leaves the CDPs. This request for confirmation was made in 2002, long after the issuance of the guidance documents upon which Devon now relies. It is perplexing, to say the least, that Devon was seemingly confused over the propriety of its royalty accounting if, in its view, the matters at issue had been authoritatively resolved over five years earlier. In other words, there is much force to DOI's argument that, in fact, the guidance documents were far from conclusive in what they said.

Second, implicit in Devon's prior-inconsistent-interpretation argument is a claim that the judgments reached in DOI's Valuation Determination and Final Order do not reflect a supportable interpretation of the marketable condition rule. As we have already explained in part II.B, *supra*, we find no merit in this claim. Although the marketable condition rule is ambiguous and Devon's preferred construction of the rule is not unreasonable, we are obliged to defer to the agency's reasonable construction of the rule. *Thomas Jefferson Univ.*, 512 U.S. at 512 (holding that an agency's interpretation of its own regulation is entitled to "substantial deference," unless "plainly erroneous or inconsistent with the regulation").

Third, and most important, Devon is mistaken in its argument that the guidance documents constituted authoritative and binding interpretations of the marketable condition rule. In rejecting Devon's argument, we start with the principle that agency actions do not have the force of law unless

they "mark the consummation of the agency's decisionmaking process" and either determine "rights or obligations" or result in discernible "legal consequences" for regulated parties. *Bennett v. Spear*, 520 U.S. 154, 177-78 (1997). The "Dear Operator" letter certainly does not satisfy this standard. Indeed, this court has previously considered a different aspect of the very same "Dear Operator" letter that is at issue in this case. *See Amoco*, 410 F.3d at 732.

In *Amoco*, coalbed methane producers challenged an Assistant Secretary's decision that cited the April 22, 1996 letter, arguing that it constituted a new rule that the agency could promulgate only through notice-and-comment rulemaking. Citing *Independent Petroleum Ass'n of America v. Babbitt*, 92 F.3d 1248, 1256-57 (D.C. Cir. 1996), the court rejected Amoco's argument because the letter was not binding on the agency:

> As in *Babbitt*, the Payor Letter here is not an agency statement with future effect because nothing under DOI regulations vests the Letter's author – in *Babbitt* and this case MMS's Associate Director for Royalty Management – with the authority to announce rules binding on DOI. *Id.* at 1256. "The letter is not an agency rule at all, legislative or otherwise, because it does not purport to, nor is it capable of, binding the agency." *Id.* at 1257.
>
> . . . .
>
> The sort of "workaday advice letter[s] that agencies prepare countless times per year in dealing with the regulated community," *Indep. Equip. Dealers Ass'n v. EPA*, 372 F.3d 420, 427

> (D.C. Cir. 2004) (internal quotation marks omitted), do not retroactively become agency rules whenever they are referenced in an agency decision.

Amoco, 410 F.3d at 732.

In response to the *Amoco* holding, Devon says that it "does not contend that the 1996 Dear Operator letter in and of itself was a binding rule. Rather, Devon contends that the regulatory interpretation it relied on was authoritatively adopted by the agency through the cumulative effect of a number of agency actions, including but not limited to, the issuance of the 1996 Dear Operator letter." Devon Reply Br. at 14. There are two problems with this argument. First, it assumes that the two internal memoranda written by the Deputy Director of the Minerals Management Service in 1995 to the Associate Director for Royalty Management and the Associate Director for Policy and Management Improvement were final and binding agency interpretations of the marketable condition rule. Second, it assumes that the guidance documents have the force of law because Devon followed the advice contained in the documents. There is no merit to these contentions.

Devon argues that these 1995 documents were conclusive because they reflected the actions of the Royalty Policy Board, as if to suggest that the Board had authority to adopt regulations or guidelines that bind the agency. But when questioned about this at oral argument, Devon's counsel readily conceded that the Royalty Policy Board had no authority to issue authoritative guidelines, and that the guideline documents did not have the force of law. This

concession is unsurprising, because there is *nothing* in the record here to indicate that the guidance documents purported to have the force of law.

At the very least, a definitive and binding statement on behalf of the agency must come from a source with the authority to bind the agency. *See Ctr. for Auto Safety v. Nat'l Highway Traffic Safety Admin.*, 452 F.3d 798, 810 (D.C. Cir. 2006) (holding that Associate Administrator for Safety Assurance had no authority to issue guidelines with binding effect on agency); *Ass'n of Am. R.Rs. v. DOT*, 198 F.3d 944, 948 (D.C. Cir. 1999) (holding a letter and two emails from lower level officials did not amount to an authoritative agency interpretation); *Paralyzed Veterans of Am. v. D.C. Arena L.P.*, 117 F.3d 579, 587 (D.C. Cir. 1997) (stating that a speech of a mid-level official of an agency "is not the sort of 'fair and considered judgment' that can be thought of as an authoritative departmental position") (citing *Auer v. Robbins*, 519 U.S. 452, 462 (1997)); *Amoco*, 410 F.3d at 732 (noting "Dear Operator" letter not binding on agency because not authored by official with authority to announce binding rules). The guidance documents at issue here do not satisfy this standard.

Fourth, resting on its "reliance" theory, Levon suggests that the agency is bound by the guidance documents because, for a number of years, regulated parties followed the advice contained in the documents. This argument fails. In *Center for Auto Safety*, 452 F.3d 798, a case very much on point, the court held that policy guidelines issued by the Associate Administrator of the National Highway Traffic Safety Administration did not amount to a binding rule. The contested guidelines, which

related to automakers' voluntary regional recalls, were found not binding because the Associate Administrator had no authority to issue binding regulations or make a final determination on the issue. Importantly, the court also rejected the petitioner's argument that, merely because the agency and automakers had followed the guidelines for seven years, the guidelines had binding "legal consequences." In addressing this point, the court said:

> The flaw in appellants' argument is that the "consequences" to which they allude are practical, not legal. It may be that, to the extent that they actually prescribe anything, the agency's guidelines have been voluntarily followed by automakers and have become a de facto industry standard for how to conduct regional recalls. But this does not demonstrate that the guidelines have had *legal consequences.* The Supreme Court's decision in *Bennett* makes it quite clear that agency action is only final if it determines "rights or obligations" or occasions "*legal* consequences." 520 U.S. at 178. (citation and internal quotation marks omitted). Circuit case law cannot obviate the holding of *Bennett.*

Ctr. for Auto Safety, 452 F.3d at 811. *See also Nat'l Ass'n of Home Builders v. Norton*, 415 F.3d 8, 15 (D.C. Cir. 2005) ("[I]f the practical effect of the agency action is not a certain change in the legal obligations of a party, the action is non-final for the purpose of judicial review.").

Devon argues that our decisions in *Alaska Professional Hunters Ass'n v. FAA*, 177 F.3d 1030 (D.C. Cir. 1999), and *Paralyzed Veterans of America*,

117 F.3d 579, should control the disposition of this case. We disagree. In *Alaska Professional*, the court found that thirty years of uniform advice by the Alaskan regional office of the FAA "became an authoritative departmental interpretation" binding on the agency. The case is plainly distinguishable, however, because the disputed agency advice in that case had been upheld in a formal adjudication by the Civil Aeronautics Board, FAA's predecessor agency. *See Alaska Prof'l*, 177 F.3d at 1034 (discussing *Administrator v. Marshall*, 39 C.A.B. 948 (1963)). Indeed, the decision in *Alaska Professional* acknowledges that an interpretation or advice by an official without authority to bind the agency alone would not amount to an authoritative interpretation. *Alaska Prof'l*, 177 F.3d at 1035; *see also Hudson v. FAA*, 192 F.3d 1030, 1036 (D.C. Cir. 1999) (distinguishing *Alaska Professional* as concerning a binding interpretation on the basis of the formal adjudication upon which the longstanding practice was based); *Ass'n of Am. R.Rs.*, 198 F.3d at 949 (same). In this case, by contrast, the guidance documents have never been upheld in an agency adjudication, nor have they ever been endorsed in any other agency action having the force of law.

Paralyzed Veterans also lends no support to Devon's position. In that case, we held that Advisory Board guidelines that were not clearly adopted by the Department of Justice and a speech by a mid-level official did not amount to a binding interpretation of its regulation implementing the Americans with Disabilities Act. 117 F.3d at 588. The court noted that if the Department itself had adopted the Board's interpretation of the regulation

the outcome might have been different. *Id.* The case surely does not stand for the proposition that guidance documents written by persons without authority to bind an agency and released with no indication that the documents purported to have the force of law may be taken as binding interpretations of an agency regulation.

In sum, we find no merit in Devon's claim that it acted in reliance on the 1995 and 1996 guidance documents and that this "reliance interest is protected by the APA." As noted above, the guidance documents were far from conclusive in what they said. 20 In any event, on the record here, it is plain that the contested guidance documents did not come from sources who had the authority to bind the agency. Therefore, it does not matter whether the appellant, or others, followed the advice that was offered in these documents. These documents did not amount to a binding interpretation of the marketable condition rule, so the Agency was free to adopt the interpretation at issue in this case without providing an opportunity for notice and comment.

III. CONCLUSION

For the reasons indicated above, we deny Devon's challenge to DOI's Final Order and affirm the District Court's judgment in favor of the agency.

APPENDIX B

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

DEVON ENERGY CORPORATION,	)	
	)	
Plaintiff,	)	
	)	
v.	)	
	)	Civil Action No.
GALE A. NORTON,	)	04-CV-0821 (GK)
Secretary of the Interior,	)	
	)	
Defendant.	)	
	)	

ORDER

For the reasons stated in an accompanying memorandum opinion, it is this 23rd day of August, 2007 hereby:

ORDERED: that plaintiff's motion for summary judgment [dkt #24] is DENIED; and it is further

ORDERED: that defendant's cross-motion for summary judgment [dkts #28 & #29] is GRANTED; and it is further

ORDERED: that this matter is DISMISSED WITH PREJUDICE.

/s/

Louis F. Oberdorfer
UNITED STATES
DISTRICT JUDGE

UNITED STATES DISTRICT COURT FOR THE DISTRICT OF COLUMBIA

DEVON ENERGY CORPORATION,	)	
	)	
Plaintiff,	)	
v.	)	Civil Action No.
	)	04-CV-0821 (GK)
GALE A. NORTON,	)	
Secretary of the Interior,	)	
	)	
Defendant.	)	
	)	

MEMORANDUM OPINION

Plaintiff Devon Energy Corporation ("Devon"), a natural gas producer, seeks review of a decision by the Department of the Interior ("Interior").[1] Interior held that Devon could not deduct certain costs when it calculated the royalties owed to the government pursuant to its lease to extract natural gas from federally-owned land. Devon principally argues that Interior's decision violates the notice and comment provisions of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553, because it reinterprets Interior regulations in a manner fundamentally different from the agency's prior interpretation of the same regulations. The following analysis establishes that Interior did not reinterpret a prior authoritative interpretation of its regulations in violation of the APA, and hence was not required to conform to the APA's notice and comment provisions.

---

[1] Judge Gladys Kessler referred the pending motions for summary judgment to this judge on December 22, 2006.

BACKGROUND

A. Statutory and Regulatory Background[2]

Beginning in the 1980s, technological innovations made possible the large-scale extraction of a natural gas variety known as "coalbed methane." Coalbed methane is gas that is trapped in underground coal seams and held in place by hydraulic pressure. To extract the gas, a producer like Devon lifts the pressure on the coalbed, causing the coalbed methane to escape. The gas is then captured and gathered to a central delivery point ("CDP"); removed of any excess carbon dioxide; and dehydrated and pressurized to render it suitable for transport. Only by completing this process does coalbed methane become marketable for use.

The federal government owns land in the Powder River Basin of Wyoming, which is rich in natural gas. It leases rights to extract the gas in exchange for a statutorily fixed percentage of the proceeds.[3] Interior, through its subagency the Minerals Management Service (MMS), promulgates rules for

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[2] Much of the following statutory and regulatory background has been taken, without attribution for ease of readability, from then-Judge Roberts' opinion in *Amoco Production Co. v. Watson*, 410 F.3d 722 (D.C. Cir. 2005), and the Supreme Court's opinion in *Amoco Production Co. v. Southern Ute Indian Tribe*, 526 U.S. 865 (1999).

[3] The Mineral Leasing Act requires producer-lessees to pay the government-lessor "a royalty at a rate of not less than 12.5 percent in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226(b)(1)(a).

the regulation of the relationship between the government and its natural gas lessees, and issues and administers the leases in accordance with those rules.

In 1988 MMS "amended and clarified" the rules "governing valuation of gas for royalty computation purposes." Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230 (Jan. 15, 1988). These new rules specified that the "value of production" referred to in 30 U.S.C. § 226(b)(1)(A) must be no less than "the gross proceeds accruing to the lessee for lease production," minus certain allowable deductions. 30 C.F.R. § 206.152(h) (1988). A longstanding interpretation of the Mineral Leasing Act (MLA) obligates lessees to put the gas they extract in "marketable condition at no cost to" the federal lessor, thereby precluding deduction of such costs. *Id.* § 206.152(i); *see California Co. v. Udall*, 296 F.2d 384, 387-88 (D.C. Cir. 1961) (upholding marketable condition requirement).

Lease products are considered in marketable condition if they "are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. § 206.151. If a lessee sells "unmarketable" gas at a lower cost, the gross proceeds for purposes of royalty calculation must be "increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services" to place the gas in marketable condition. *Id.* § 206.152(i). To take a simple example, if it costs a producer $20 to put gas in marketable condition by dehydrating and compressing it, and the producer

sells the dehydrated and pressurized gas for $100, "gross proceeds" for purposes of royalty calculations is $100, regardless of whether the producer dehydrates and pressurizes and then sells the gas for $100, or instead sells the gas for $80 to a purchaser who dehydrates and pressurizes it.

Importantly, the regulations allow lessees to deduct from gross proceeds costs directly related to transporting the gas from the wellhead for sale at markets remote from the leasehold.

See id. § 206.157(a)-(b).

B. Factual Background

The facts of this case are undisputed.

Devon is a producer of coalbed methane and a lessee of the federal government in Wyoming's Powder River Basin. Devon gathers the gas from various wells in the Basin to CDPs, where the gas is measured to calculate the amount of royalty owed to the federal lessor. Pl.'s Stmt of Material Facts as to Which There Is No Genuine Issue ("Pl.'s Stmt") ¶¶ 2-4 (May 4, 2005) [dkt #24].

After being gathered to the CDP, the coalbed methane leaves the CDP through a pipeline to one of Devon's chemical plants, some 126 miles away. There Devon removes the excess carbon dioxide thereby rendering the gas into marketable condition for sale to third parties. To travel the pipeline, however, the gas also must be compressed and dehydrated. As noted above, Interior regulations permit Devon to deduct from their gross proceeds the costs relating to the transport of the gas to the chemical plant. However, the marketable condition

rule prohibits deductions of costs necessary to render the gas saleable "under a sales contract typical for the field or area," 30 C.F.R. § 206.151. The regulations do not expressly state whether the costs of dehydrating and compressing coalbed methane are (a) deductible transportation costs or (b) nondeductible costs for rendering the gas into marketable condition. *See* Pl.'s Stmt ¶¶ 5-10.

In November 1995 Interior convened the Royalty Policy Board to consider how the marketable condition rule should be interpreted with regard to these compression and dehydration costs. In 1995-96, the guidance generated from this meeting was distributed by way of two valuation and reporting Guidelines (the "Guidelines") published on Interior's website, as well as a Dear Operator Letter (the "Letter") sent to interested parties. *See id.* ¶¶ 12-21.

The parties dispute the meaning of the Board's specific guidance in the Guidelines and Letter. According to Devon, the Board allowed the producer to deduct the costs of dehydration and compression, provided they were incurred after the gas reached the CDP and were necessary for transportation. *See* Pl.'s Stmt of Points and Authorities in Support of Pl.'s Mot. for Summ. J. ("Pl.'s Mem.), at 9-10 (May 4, 2005) [dkt # 24]; Def.'s Mem. in Opp. to Pl.'s Mot. for Summ. J. ("Def.'s Mem."), at 9-10 (Jun. 17, 2005) [dkt #28]. According to Interior, the Board's conclusions were ambiguous and, if interpreted as Devon viewed them, erroneous. *See id.*; Def.'s Rep. to Pl.'s Opp. to Def.'s Cross-Mot. for Summ. J. ("Def.'s Rep."), at 7-10 (Aug. 17, 2005) [dkt #33]. Moreover, declares Interior, the Board was without authority to issue a binding, authoritative interpretation of the

marketable condition rule on behalf of the agency. *See id.* at 16.

In 2002, Devon requested that MMS confirm that deducting the post-CDP dehydration and compression costs from the royalty calculation, as set forth in the Guidelines and Letter, complied with Interior's marketable condition regulation. Pl.'s Stmt ¶ 26. In 2003, an Acting Assistant Secretary of the Interior ruled in a final agency decision that the Royalty Policy Board's interpretation of the regulations was either ambiguous or in error, and that Devon could not deduct the post-CDP dehydration and compression costs as transportation costs. *Id.* ¶ 27; Compl., Ex. B, at 25 (Agency Decision of Oct. 9, 2003) [dkt #1]. This litigation followed.

DISCUSSION

I. The Legal Standard

Summary judgment is granted if there is no genuine issue as to any material fact and if the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). The standard of judicial review of Interior's interpretation of its own regulations implementing the MLA, the case here, is well known:

> Although [the courts] will not allow an agency to rewrite regulations under the guise of interpreting them, [they] nevertheless owe substantial deference to an agency's interpretation of its own regulations, giving that interpretation controlling weight unless it is plainly erroneous or inconsistent with the regulation. Such deference is particularly appropriate in the context of a complex and

> highly technical regulatory program [such as the MLA], in which the identification and classification of relevant criteria necessarily require significant expertise and entail the exercise of judgment grounded in policy concerns.

Amoco Production Co. v. Watson, 410 F.3d 722, 728-29 (D.C. Cir. 2005) (original alterations, quotation marks, and citations omitted).

II. APA § 553 Claim

Section 553 of the APA requires that a formal administrative rule be implemented through notice and comment procedures. *See Independent Petroleum Assoc. of America v. Babbitt*, 92 F.3d 1248, 1256 (D.C. Cir. 1996). The D.C. Circuit has also ruled, however, that "[o]nce an agency gives its regulation an interpretation, it can only change that interpretation as it would formally modify the regulation itself: through the process of notice and comment rulemaking." *Paralyzed Veterans of America v. D.C. Arena*, 117 F.3d 579, 586 (D.C. Cir. 1997). The question here is whether the Guidelines and Letter constitute an "authoritative interpretation," *id.*, of the marketable condition rule, such that Interior's repudiation in the decision presently under review must undergo notice and comment procedures. All parties agree that the Guidelines and Letter, standing alone, do not constitute an authoritative interpretation of a rule sufficient to bind the agency. *See Independent Petroleum*, 92 F.3d at 1256-57; Pl.'s Rep. in Supp. of Its Mot. for Summ. J. & Its Opp. to Def.'s Cross-Mot. ("Pl.'s Rep."), at 6 & n.4 (Jul. 13, 2005) [dkt #30]. Rather, Devon argues that these guidances plus subsequent actions by Interior comporting with their

interpretation is sufficient to bind the agency as an authoritative interpretation. *Id.*

The parties present two diverging paradigms for understanding the nature of Interior's actions. From Devon's perspective, the 1995-96 Guidelines and Letter uttered by the Royalty Policy Board constitute a new and not unreasonable interpretation of the marketable condition rule that has been in effect for over 60 years. The new interpretation of the rule was necessary to address the technological innovations in the 1980s making profitable the collection of coalbed methane. Thus, the Board was called upon to decide how the marketable condition rule would apply to this relatively recent practice of collecting and refining coalbed methane. In other words, Devon argues, the Guidelines and Letter are a new *application* of the marketable condition rule, which are binding on Interior.

Even if Devon's paradigm were correct, that does not mean it wins. As Devon acknowledges, the policy statements or informal interpretations in the Guidelines and Letter are not binding on Interior, *unless Interior affirmatively adopted them*, by way of complying with them in a longstanding practice. *See Alaska Professional Hunters Ass'n v. FAA*, 177 F.3d 1030, 1035 (D.C. Cir. 1999).

Interior's paradigm is quite different. Interior views the 1995-96 Guidelines and Letter as an anomaly or error in a long line of Interior policy statements and interpretations that have consistently interpreted, for decades, the marketable condition rule in accordance the view taken by the 2003 decision rejecting Devon's interpretation. Interior de-emphasizes the significance of the

newness of coalbed methane collection, noting instead that the original marketable condition rule applies to *all* natural gas. It cites a long line of adjudications and federal court decisions applying the marketable condition rule consistently with the 2003 decision, regardless of whether the costs of bringing the gas to a marketable condition were incurred before the gas reaches the CDP, at the CDP, or after it has passed through the CDP. According to Interior, the Guidelines and Letter (or Devon's interpretation of them) are an anomaly that sticks out like a sore thumb.

Moreover, Interior disputes that it ever authoritatively adopted the interpretation stated in the Guidelines and Letter. Although it acknowledges that since 1995-96 its employees may have approved deductions for coalbed methane like the ones Devon wishes to make, it also notes at least one instance since that time when it did not allow such a deduction. Moreover, Interior cites numerous decisions where, with respect to natural gas, it uniformly denied a transportation deduction based upon the geographic location (*i.e.*, downstream of the CDP) of the natural gas.

Interior has the better of the argument.

In favor of its paradigm, Devon relies principally on two cases, neither of which is controlling here. The first is *Shell Offshore Inc. v. Babbitt*, 238 F.3d 622 (5th Cir. 2001), in which the Fifth Circuit, purportedly relying on the D.C. Circuit's holding in *Alaska Professional*, held that Interior could not require an additional certification from FERC as a prerequisite to receiving a particular transportation deduction. The Fifth Circuit held that Interior's

"undeniably . . . long established and consistently followed practice" of not requiring an additional certification could not be altered without notice and comment. *Id.* at 630. Next Devon relies upon a district court case, *Torch Operating Co. v. Babbitt*, 172 F. Supp. 2d 113 (D.D.C. 2001), holding, on virtually the same facts as *Shell Offshore*, that Interior had failed to comply with APA notice and comment procedures before requiring the certification overlay for the approval of transportation deductions. *Id.* at 128.

These two cases facially appear to have analogous facts to the decision now under review. However, in both *Shell Offshore* and *Torch* there was no question that Interior had made a change in policy and departed significantly from a consistent, prior practice of not requiring the certification. *See Shell Offshore*, 238 F.3d at 630 (prior interpretation was "undeniably" a long established and consistently followed practice); *Torch*, 172 F. Supp. 2d at 125-26 (same). By contrast, in the case *sub judice*, there is considerable doubt whether Devon's preferred interpretation of the marketable condition rule is consistent with Interior's longstanding position that the rule does not permit deduction of costs based upon the geographic location of where the costs were incurred (here, upon leaving the CDP). *See Amoco*, 410 F.3d at 729 (upholding Interior's position in this regard). That is to say, it is not all clear that the 2003 decision is a departure from a longstanding practice of Interior. This alone suffices to distinguish the situation here from the cases relied upon by Devon, neither of which is controlling here.

Two cases that are controlling, on the other hand, address precisely the prerequisites necessary for guidances such as the Guidelines and Letter to become a definitive interpretation, binding on the agency and alterable only by way of notice and comment. In both cases, the D.C. Circuit held that where the agency's prior interpretation of a regulation—alleged to be invulnerable to change absent notice and comment—is either ambiguous (that is, not clearly a departure from the subsequent, definitive interpretation) or a mere policy statement, it is not binding on the agency, and the agency may render later decisions arguably inconsistent with the policy statement or ambiguous interpretation. Here, the Guidelines and Letter constitute a policy statement of enforcement, not an interpretation of the marketable condition rule; and even if considered such an interpretation, the interpretation is ambiguous, and hence Interior's 2003 decision rejecting Devon's deductions is not inconsistent with the marketable condition rule.

In the first case, *Hudson v. FAA*, 192 F.3d 1031 (D.C. Cir. 1999), the D.C. Circuit held that a 1989 advisory circular issued by the FAA was a policy statement rather than an interpretation of an FAA regulation and therefore not subject to the administrative law principle that a prior authoritative interpretation of a regulation can only be changed by notice and comment rulemaking. *Id.* at 1036 (*Alaska Professional*, 177 F.3d at 1035, and *Paralyzed Veterans*, 117 F.3d at 586, distinguished). The FAA's 1989 advisory circular called for actual demonstrations of an aircraft's safety but warned that these were "not the only means[] of compliance"

with FAA's regulatory requirements. *Id.* at 1033 (quoting the circular). The court held that abandoning the demonstration requirement did not require notice and comment.

Likewise, the Guidelines and Letter (allegedly) allow for the deductions Devon seeks from its royalty payments, but they also make clear that dehydration and compression costs that serve both transportation and marketable condition costs "should be referred to [MMS] to determine the appropriate allocation." Compl., Ex. G, Guidelines Memorandum, at 2 (Dec. 8, 1995); *id.*, Ex. H, Dear Operator Letter, at 3 (Apr. 22, 1996) (same); *see also id.*, Ex. F, Guidelines Memorandum, at 2 (Dec. 7, 1995) (confirming that lessee has burden of proving that dehydration and compression costs were related to transportation). Nothing in the Guidelines or Letter purports to reinterpret definitively the marketable condition rule with respect to coalbed methane. Rather, the guidance was issued at the request of several coalbed methane producers in San Juan, Arizona, because of confusion over their allowable costs. At that time, perhaps, MMS had a policy of allowing dehydration and compression costs that occurred post-CDP; but that does not mean Interior's decision to disallow the costs now is invalid: That decision "is not a different interpretation of the regulation, just an application of the regulation to a changed situation which calls for a different policy." *Hudson*, 192 F.3d at 1036.

Second, in *Darrell Andrews Trucking v. FMCSA*, 296 F.3d 1120 (D.C. Cir. 2002), the court of appeals held that a plaintiff making Devon's claim "must show that the 'agency has given its regulation a definitive interpretation, and later significantly

revise[d] that interpretation.'" *Id.* at 1125 (quoting *Alaska Professional*, 177 F.3d at 1034). The court held that where the agency has issued ambiguous guidances concerning its position on a regulation, as well as a clear decision that adhered to the agency's most recent understanding of the regulation, the ambiguous guidances did not constitute a binding "definitive interpretation." *See id.* at 1127-28. Likewise, here the Guidelines and Letter are arguably ambiguous (though Devon contends they are not). But even if the guidances are construed in favor of Devon's interpretation, a formal adjudication by Interior repudiates that view, *see J-W Operating Co.*, 159 IBLA 1, 12 (2003) (noting that "it has been held repeatedly that the [the costs for] dehydration of gas to meet market specifications for water content and the compression of gas to the pressure required for entry into the buyer's pipeline are not deductible"), and Interior cites at least one instance where Devon's position on calculating coalbed methane royalties was rejected by the agency, *see* Def.'s Rep., Ex. A. In light of this clear conflict, the balancing of which favors Interior's interpretation of the regulation, to paraphrase the D.C. Circuit in *Darrell Andrews*, "in the midst of the period in which [Interior] issued the ambiguous [Guidelines and Letter] relied upon by [Devon], it issued a clear decision that confirms the interpretation applied by the agency in this case. [Devon] is therefore unable to show that the decision below represents a substantial change in the agency's construction of" the marketable condition rule and cannot sustain a challenge under *Alaska Professional*. *Darrell Andrews*, 296 F.3d at 1128.

Finally, a word on *Alaska Professional*, upon which Devon relies heavily. In that case, the D.C. Circuit ruled that an agency violates § 553 when it affirmatively adopts an interpretation, by way of complying with that interpretation through longstanding practice, and then repudiates that interpretation without notice and comment. 177 F.3d at 1033-34 (relying on *Paralyzed Veterans*, 117 F.3d at 586). However, the court was careful to note that "when [an unauthoritative body] gives an interpretation of a regulation or provides advice to a regulated party, this will not necessarily constitute an authoritative administrative position, particularly if the interpretation or advice contradicts the view of the agency as a whole," and hence a subsequent rejection by the agency of that position will not violate § 553. *Id.* at 1035. Here, the views of the Royalty Policy Board are not authoritative on behalf of Interior. Devon concedes as much by acknowledging that absent some sort of longstanding, consistent adherence to the Guidelines and Letter, it cannot sustain its cause based on the Board's guidances. *See* Pl.'s Rep., at 5-6 & n.4; *Amoco*, 410 F.3d at 732 (holding that MMS guidance letters are not binding on the agency, and citing *Independent Petroleum*, 92 F.3d at 1257). Also, as the *Hudson* case made clear, *Alaska Professional* was a unique situation where the agency had adhered to a particular interpretation of the regulation for some thirty years, issuing formal adjudications that were consistent with and adopted that interpretation, before repudiating it. *See Hudson*, 192 F.3d at 1036; *Ass'n of American Railroads v. DOT*, 198 F.3d 944, 950 (D.C. Cir. 1999) (noting *Alaska Professional* relied on "administrative common law" to

substantiate the original interpretation). Finally, *Alaska Professional*'s holding has been further narrowed on the ground that it applies only where a turnabout in interpretation upsets substantial financial expectations based upon the original interpretation. *Id.*

III. APA § 706 Claim

Devon also claims that disallowing the post-CDP deductions for dehydration and compression costs is an unreasonable reading of the marketable condition regulation, and hence "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law," 5 U.S.C. § 706. However, the judicial standard of reviewing with deference an agency's interpretation of its own regulations prevents overturning it pursuant to APA § 706. *See Auer v. Robbins*, 519 U.S. 452, 461-463 (1997); *Amoco*, 410 F.3d at 728-29; *see also Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-845 (1984).

Devon argues that Interior's interpretation of "marketable condition," that is, gas conditioned for the specific market into which it is actually sold, is contrary to the plain language of the regulation which defines marketable condition as gas conditioned to such an extent that it "will be accepted by a purchaser under a sales contract typical for the field or area," 30 C.F.R. § 206.151. However, this argument is foreclosed by *Amoco*, which held, in rejecting a substantially similar argument, that the regulation "does not contain a geographic limit." *Amoco*, 410 F.3d at 729. Devon also argues, much like the plaintiff in *Amoco*, that Interior departed from agency precedent and original

intent in issuing the 2003 decision prohibiting deduction of costs that were incurred past the geographical boundary of an off-lease central accumulation point. That argument also is foreclosed by the *Amoco* decision. *Id.* at 730. Finally, Devon argues, halfheartedly, that it alone is subject to the (allegedly) grievous 2003 Interior decision, and hence is being treated unfairly in comparison with other similarly situated gas producers. The argument is without merit, and Devon acknowledges that Interior has already begun to apply the 2003 decision to other gas producers. *See* Pl.'s Praecipe (Oct. 7, 2005) [dkt #40].

CONCLUSION

For the foregoing reasons, an accompanying order will deny plaintiff's motion for summary judgment and grant Interior's cross-motion for summary judgment.

/s/

Louis F. Oberdorfer
UNITED STATES
DISTRICT JUDGE

Dated: August 23, 2007

APPENDIX C

United States Department of the Interior
OFFICE OF THE SECRETARY
Washington, DC 20240

MAR 19, 2004

CERTIFIED MAIL –
RETURN RECEIPT REQUESTED

Mr. Gregg Henson
Assistant Controller
Devon Energy Corp.
20 North Broadway, Suite 1500
Oklahoma City, Oklahoma 73102-8260

Ms. Deborah Bahn Haglund
Haglund Law Firm
102 So. Broad St., Suite C
Cedar Hill, Texas 75104

Re: Request for Reconsideration or Clarification of Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, Powder River Basin, Wyoming, dated October 9, 2003

Final Order to Perform Restructured Accounting and Pay Additional Royalties

Dear Mr. Henson and Ms. Haglund:

By letter from Ms. Haglund as counsel for Devon Energy Corp. (Devon) dated December 8, 2003, Devon requested "reconsideration and/or clarification" of the "Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, Powder River Basin, Wyoming," dated October 9, 2003, (the "October 9

Determination"). This letter responds to that request ("the December 8 Request"), and also includes a final order to Devon to perform a restructured accounting and pay additional royalties due, as set forth more fully below. We will address these different components of the December 8 Request in the same order as they are raised. The October 9 Determination is incorporated herein by reference for all purposes.

RESPONSE TO REQUEST FOR RECONSIDERATION OR CLARIFICATION

I. Specific Ordering Language

The December 8 Request first observes that the October 9 Determination did not contain express mandatory or ordering language. We acknowledge that such language was not included in the October 9 Determination. Specific ordering language is included in this response below.

II. "Bundled Volumetric Fuel Deductions" and "Bundled Arm's-Length Transportation Rate"

Second, the December 8 Request (at p. 2) states that Devon "historically has not paid royalty on the bundled volumetric fuel deductions made by Bitter Creek and Thunder Creek, since it considers the entirety of this fuel to be part of its transportation cost." The original letter requesting the valuation determination, dated January 11, 2002, described the arrangements with Thunder Creek and Bitter Creek as follows:

> Devon has separate low-pressure transportation agreements with its affiliate,

> Thunder Creek Gas Services, L.L.C., for the Kitty Field and Spotted Horse areas.
>
> Devon has a low-pressure transportation agreement with Bitter Creek Pipelines, L.L.C., for the Rough Draw Field.
>
> * * *
>
> Devon has a high-pressure transportation agreement with Thunder Creek Gas Services, L.L.C., to move gas from any point on its high-pressure line to the tailgate of the Buckshot Plant.

January 11, 2002 request letter, p. 3. Thunder Creek is an affiliate of which Devon owns 75 percent. The low-pressure Thunder Creek lines are the lines extending from each of the central delivery points (CDPs) through the respective reciprocating compressors/field boosters and their associated dehydrators in the Kitty and Spotted Horse Fields. The Thunder Creek high-pressure system begins after the reciprocating compressors/field boosters and their associated dehydrators and extends to the terminus of the Thunder Creek line at the Buckshot Plant near Glenrock, Wyoming. The Bitter Creek low-pressure line (operated by Williston Basin) extends from the CDPs through the reciprocating compressors and associated dehydrators in the Rough Draw Field.

The January 11, 2002 request letter then specifically states, with respect to the Thunder Creek low-pressure systems (at p. 4):

> Since Devon owns 75 percent of Thunder Creek, the deduction [for the costs of the low-

> pressure pipeline system that Devon took] is based on a cost-of-service calculation, including actual fuel, rather than on the basis of the contract prices. Since service is purchased from Thunder Creek on an MMBtu basis, there are no costs associated with transporting CO_2.
>
> Attachment B sets forth a summary of calculations of rates based on the actual costs associated with capital investment, operating, and maintenance costs, with capital and depreciation calculated in accordance with MMS guidelines. Supporting information is provided on Attachment B-1. (Emphasis added.)

With respect to the Thunder Creek high-pressure system, the January 11, 2002 request letter (at p. 4) similarly states:

> Since Devon owns 75 percent of Thunder Creek, the deduction is based on a cost-of-service calculation, including actual fuel used by the pipeline. Since the contract with Thunder Creek is on a MMBtu basis, there are no costs associated with transporting CO_2.
>
> Attachment B sets forth a summary of calculations of rates based on the actual costs associated with capital investment, operating, and maintenance costs, with capital and depreciation calculated in accordance with MMS guidelines. Supporting information is provided on Attachment B-1.

With respect to the Bitter Creek low-pressure system, the January 11, 2002 request letter states (at p. 4):

> The contract is on an MMBtu basis and there are no costs associated with transporting CO_2. Since Williston Basin Interstate operates this transportation system, this transaction is arm's length and the basis for the deduction is the contract-rate, including pipeline fuel usage and lost and unaccounted for volumes.

We understand from further discussions between Devon's counsel and counsel for MMS concerning the "bundled volumetric fuel deductions" that the information that Thunder Creek furnished to Devon showed that for each of the two Thunder Creek low-pressure systems (Kitty and Spotted Horse), Thunder Creek deducted one overall volume amount from the gas that went through the system for all fuel used to power that system's operations. That includes primarily the screw compressors, reciprocating compressors/field boosters, and the dehydrators associated with the reciprocating compressors. There was also a relatively small percentage of the fuel gas that was used to power heaters for small buildings in which meters were located and to power tank heaters. In the December 8 Request, Devon refers to this figure as a "bundled" deduction because the figure given by Thunder Creek was not further broken down — *i.e.*, it did not itemize the fuel deductions by each particular compressor or dehydrator that the deducted volume was used to power. Devon refers to it as a "volumetric" deduction because the fuel was taken

from the gas flowing through the system and was not a payment in cash.

We further understand that the same is true for the Thunder Creek high-pressure system. In other words, Thunder Creek's information to Devon showed one overall volume amount deducted from the gas that went through the high-pressure system to power that system. This fuel primarily served to power the MTG Booster and compression at the Buckshot plant.

Finally, we understand that Bitter Creek likewise deducted one stated volume amount from the gas that passed through the Bitter Creek low-pressure system in the Rough Draw Field to power that system. Devon also paid some cash amounts to Bitter Creek as part of the payment under the arm's-length agreement between them. As was the case for the Thunder Creek low-pressure systems in the Kitty and Spotted Horse Fields, the deducted fuel volumes powered primarily the screw compressors, the reciprocating compressors, and the associated dehydrators. Presumably, a small percentage of the deducted volumes powered building heaters and tank heaters.

For the reasons explained in the October 9 Determination, none of the compressor and dehydrator costs for the Thunder Creek and Bitter Creek low-pressure systems are deductible. This would include fuel costs, whether paid in cash or paid (as here) as an in-kind deduction from the gas

flowing through the system.[1] With respect to these low-pressure systems, Devon's request that the Department "clarify" the October 9 Determination to "expressly state that Devon may continue to treat the entirety of the bundled volumetric fuel deductions made by Bitter Creek and Thunder Creek as part of its allowable transportation cost" appears to be simply a request to reverse the holding and result of the October 9 Determination. Devon has not shown why the costs of the screw compressors and the reciprocating compressors are not part of the costs incurred to put production into marketable condition, and has offered nothing to refute the analysis of the October 9 Determination. Devon therefore must determine the value of the deducted fuel gas used for those purposes and pay royalty on that value.

To the extent that the fuel costs for meter building heaters and tank heaters are not part of the costs of compression and dehydration and are part of the costs of the transportation line, those costs are part of the actual cost of transportation, and Devon may continue to not pay royalty on that portion of the fuel gas used for those purposes. We recognize

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[1] The documents MMS has received from Devon and Thunder Creek show, and Devon acknowledges, that all of the screw compressors with which we are concerned here are located downstream of the BLM-approved central accumulation point or point of royalty measurement. Devon therefore correctly included all production, including that portion deducted as fuel, in the royalty-bearing production removed or sold from the lease. (*See* 43 C.F.R. § 3162.7-3.)

that the "bundled" fuel deduction reported by Thunder Creek and Bitter Creek does not separately identify the fuel volumes used for each of the compressors, dehydrators, tank heaters, etc. But for Thunder Creek, Devon has access to the information to calculate the costs of the building and tank heater functions separately from the screw compressors and the reciprocating compressors and the dehydrators on the low-pressure system, because Devon owns 75 percent of Thunder Creek and can require this information from Thunder Creek. If Bitter Creek is unwilling to voluntarily disclose separate cost information to Devon for the Bitter Creek low-pressure system in the Rough Draw Field, Devon should confer with MMS to agree on an acceptable allocation between deductible and non-deductible amounts.

For the high-pressure system, the fuel costs are principally for the MTG Booster and compression at the Buckshot plant. The October 9 Determination already concluded that under the particular circumstances of this case, the costs of the MTG Booster would be allowable as transportation costs. (The costs of any other functions (other than compression at the plant) on the high-pressure system that the fuel gas was used to power likewise are deductible.) However, the costs of the compression undertaken at the Buckshot plant are not deductible. Therefore, Devon must obtain from Thunder Creek a separate calculation of the volume of fuel used for compression at the plant, determine the value of that volume, and pay royalty on that value. For the Thunder Creek high-pressure system, Devon may continue to not pay royalty on that

portion of the volumetric fuel deduction allocable to the MTG Booster and other functions of the high-pressure system unrelated to compression at the plant, subject to the limitation described in the next paragraph.

Devon's description of the Thunder Creek high-pressure system in the January 11, 2002 request letter, as quoted above, stated that "the deduction is based on a cost-of-service calculation" and because the contracts were on an "MMBtu basis" that "there are no costs associated with transporting CO_2." But because the "bundled" deduction reported by Thunder Creek as fuel was a volume deduction, it is unclear from this description whether the volume Thunder Creek reported as deducted included all fuel- including the portion of the fuel allocable to moving the CO_2 portion of the gas stream — or was limited to the portion of the fuel allocable to moving the methane only. To the extent that the deduction included the portion of the fuel allocable to moving the CO_2, that portion is not deductible as a transportation cost. Devon therefore would have to calculate the value of that portion of the deduction and pay royalty on that value.[2]

The December 8 Request (at p. 2) also states that "Devon historically has deducted the entirety of the

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[2] It is not necessary to address this issue in the context of the Thunder Creek low-pressure systems and the Bitter Creek low-pressure system because none of the compression costs for those systems are deductible for the reasons explained above.

bundled arm's-length transportation rate it pays to Bitter Creek for transportation past the central delivery point in the Rough Draw Field." Devon asks that the Department "clarify" the October 9 Determination "to expressly state that Devon may continue to deduct the bundled arm's-length transportation rate it pays to Bitter Creek." We understand from subsequent discussions with Devon's counsel that Devon paid Bitter Creek some amounts in cash under its arm's-length agreement in addition to the deducted fuel volumes. (These cash amounts are what Devon refers to by the expression "bundled arm's-length transportation rate.") Devon's understanding is that part of the cash payment covers some costs of compression and dehydration, and some covers other functions. As explained above, Devon may not deduct the costs of the screw compressors and the reciprocating compressors and the dehydrators. To the extent the "bundled arm's-length transportation rate" includes costs allocable to the compressors and the dehydrators, Devon may not deduct that portion of the transportation rate. To the extent the amounts paid in cash are not for compression or dehydration, Devon may deduct those amounts as transportation costs, for the reasons explained in the October 9 Determination. Because it appears that the amounts paid in cash consist of both deductible and non-deductible elements, Devon should consult with MMS to determine an acceptable allocation if it is unable to obtain further information from Bitter Creek.

III. Reconsideration in View of Asserted "Facts"

Third, the December 8 Request asks that the Department "reexamine" the October 9 Determination in light of what your letter styles as factual arguments. Each will be addressed in turn. Devon first argues:

> You find that, to the extent that compression occurring prior to the [Buckshot] plant is duplicative of the compression performed at the plant, it is reasonable to conclude that the primary purpose of the upstream compression is to transport the gas to the plant.
>
> The same rationale applies to the screw compressors and reciprocating compressors that you have said are not deductible, and to the dehydration associated with that compression, which you have said is also not deductible. If the Buckshot Plant had been located in the field, with slight mechanical modifications, all of this compression and dehydration could have been done at the plant, only once.
>
> The screw compressors, reciprocating compressors, and associated dehydration in the field are needed only because the gas must be transported over a hundred miles to the plant, where the gas is then compressed and dehydrated again to meet pipeline specifications. Applying your own rationale, the screw compressors, the reciprocating compressors, and the associated dehydration in the field should all be deductible as part of the cost of transporting the gas from the central delivery point in the field to the plant.

December 8 Request, pp. 2-3 (emphasis in second paragraph added; emphasis in third paragraph in original).

This argument is inconsistent with Devon's prior description of the physical operation of the compressors. According to Devon's own description, as explained in the October 9 Determination, gas was recompressed at the Buckshot Plant from approximately 800 psi to 1100 psi —not from 2-10 psi (the inlet pressure at the screw compressors) to 1100 psi. The compression performed at the screw compressors and the reciprocating compressors was not "duplicative" of compression performed at the plant.[3]

Nor would relocating the plant to a point in or near the fields have resulted in the plant duplicating the compression performed at the screw compressors and the reciprocating compressors. Had the plant

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[3] Additionally, it is appropriate to reiterate that the October 9 Determination allows the entire cost of the MTG Booster because of the impracticality of attempting to allocate its cost between non-deductible compression that was not done again at the plant (*i.e.*, increasing pressure from approximately 550-600 psi, the exit pressure from the reciprocating compressors, to approximately 800 psi, the inlet pressure at the plant), and deductible compression that was either done again at the plant (increasing pressure from 800 to 1100 psi) or that may have exceeded the pipeline delivery pressure (1200 psi minus 1100 psi). Because of the impracticality of attempting to allocate the cost of the MTG Booster, Devon effectively has been allowed a somewhat greater allowance than what it actually is entitled to under the applicable rules if an exact allocation could be performed.

been located in the field, it may have been theoretically possible to redesign the plant to make it powerful enough to draw all the gas from very low initial pressures at all of the dozens of wells over various distances (ranging up to more than 20 miles from some of the wells) and perform all compression to 1100 psi at the plant. (This presumably would have required considerably more than "slight mechanical modifications' to the plant.) But even if that had been the case, it would not have made the compression costs deductible. The hypothesis that compression could have been done in some other way does not make the compression that in fact was done at the screw compressors and 'the reciprocating compressors unnecessary. Nor does it imply that such compression was not necessary to put the production into marketable condition.

Devon next argues:

> You [the Acting Assistant Secretary] acknowledge on page 17 of your decision that "marketable condition" means "lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. §206.151. With respect to gas produced from the Powder River Basin, Devon believes that its working interest partner, Redstone Resources, Inc., sells gas to unrelated third parties in the field at pressures less than 1200 psi under contracts typical for the field or area. Based on these facts, Devon respectfully requests that you reconsider your determination that the gas produced from the

> same fields or area and sold at the tailgate of the Buckshot plant is not in marketable condition until it is compressed to 1200 psi. "

December 8 Request, p. 3. First, this argument appears to mildly mischaracterize the October 9 Determination. The October 9 Determination did not say that gas sold at the tailgate of the Buckshot plant is not in marketable condition until it is compressed to 1200 psi. As explained in the valuation determination, the documents MMS received from Devon and Thunder Creek indicated that gas is compressed at the plant to a delivery pressure of 1100 psi, not 1200 psi. The October 9 Determination holds that the gas delivered at the tailgate of the plant must be at the pressure required to enter the receiving pipeline that takes the gas to its market. In the case of that gas, that happens to be 1100 psi.

Second, Devon has done nothing more than assert that it "believes" that Redstone Resources sells other gas at pressures less than 1200 psi. Devon has put nothing into the record to show at what pressures and into what markets Redstone actually sells its gas.

Third, in any event, whether Redstone sells some gas at lower pressures ultimately is irrelevant. (Indeed, we may assume, *arguendo*, that it does so; Devon itself sells some gas at the Landeck Header at approximately 550 psi.) As explained in the October 9 Determination, whether particular gas is in marketable condition is not a function of the lowest pressure at which <u>any</u> of the gas is in marketable condition. As is the case here, gas produced from large fields may serve more than one

market. Particular gas must be in marketable condition for the market it serves, which requires that it be at the pressure necessary to enter the pipeline that takes the gas to that market. The fact that the gas sold at the Landeck Header was in marketable condition at 550 psi does not imply that all the gas is in marketable condition at that pressure.

Devon's implicit theory is analogous to the theory that the court rejected in *Amoco Production Co. v. Baca and Vastar Resources, Inc. v. Baca*, Civil Nos. 00-02933 and 00-1480 (D.D.C. Nov. 14, 2003), *appeal pending*, No. 04- _____ (D.C. Cir.). There, the lessees sold a small percentage of coalbed methane production into a small local market in the vicinity of the lease without first removing the CO_2. The lessees argued that all the gas was in marketable condition because some of it was sold without CO_2 removal. The fact that gas did not need to be conditioned to meet the requirements of the local purchaser did not imply that the rest of the gas was in marketable condition. The court held that the Secretary properly required the lessees to condition the rest of the gas to pipeline CO_2 content requirements to serve the more distant markets into which it was sold.

IV. "Prior Practice and Policy"

Finally, Devon argues that the October 9 Determination "ignore[s] the agency's prior practice and policy as reflected in the December 1995 Deputy Director's memoranda" and that notice-and-comment rulemaking is required to change the "practice." December 8 Request, p. 3. Devon relies on *Shell Offshore, Inc. V. Babbitt*, 238 F.3d 622 (5th Cir.

2001) and *Torch Operating Co. v. Babbitt*, 172 F. Supp. 2d 113 (D.D.C. 2001).

As explained in the October 9 Determination, certain specific aspects of the December 7, 1995, and December 8, 1995 internal memoranda from the then-Deputy Director of the MMS to two Associate Directors were (at least as subordinate MMS officials apparently had read them and applied them in practice) inconsistent with or misinterpreted the marketable condition rule itself. It is well established that a Federal agency is not bound by unauthorized acts of its employees. The issuance of internal memoranda between subordinate agency officials that in certain respects appear to misinterpret a rule that has been in existence for many years before those memoranda were even written does not require notice-and-comment rulemaking under the Administrative Procedure Act (APA), 5 U.S.C. § 553, to correct the subordinate officials' errors.

The situation in the instant case is not like the situation in either *Shell Offshore or Torch*. In those cases, the 1988 MMS crude oil valuation rules provided for an exception to the requirement that a lessee calculate actual transportation costs in non-arm's-length transportation situations. The exception was that a lessee could apply to use a "tariff for the transportation system approved by the Federal Energy Regulatory Commission (FERC)" in lieu of calculating actual costs. Former 30 C.F.R. § 206.105(b)(5) (1988-1999). After FERC held that it did not have jurisdiction over certain offshore pipelines, MMS, in the two cases cited, denied use of tariffs that the respective lessees had filed with

FERC unless the lessees could show that FERC did have jurisdiction to adjudicate a tariff for the pipeline. But since the promulgation of the rule in 1988, MMS had always allowed use of tariffs that merely had been filed with FERC and had never required lessees to affirmatively demonstrate FERC jurisdiction to adjudicate them. As a result, the courts in both *Shell Offshore and Torch* held that changing MMS' longstanding (and from the rule's inception, uniform) interpretation of the rule required APA notice-and-comment rulemaking.

In the instant case, the marketable condition rule pre-dated the internal MMS memoranda by at least 53 years for onshore leases and 41 years for offshore leases. The December 1995 memoranda did not reflect a longstanding and uniform agency interpretation of a regulation from the inception of the regulation. Neither *Shell Offshore nor Torch* implies that notice-and-comment rulemaking is necessary to correct any and all interpretive errors of a subordinate agency official. Devon's reliance on these cases under the current circumstances therefore is misplaced.

ORDER TO PERFORM RESTRUCTURED ACCOUNTING AND PAY ADDITIONAL ROYALTIES

Devon's deduction of the costs of the screw compressors, reciprocating compressors, dehydrators, and compression at the Buckshot plant constitutes a systemic error in Devon's royalty payments. For all of the reasons explained above and in the October 9 Determination, the Department of the Interior hereby orders Devon to perform a restructured accounting and pay additional royalties on the coalbed methane produced from the Federal leases in the Kitty, Spotted Horse, and Rough Draw Fields that are the subject of the October 9 Determination in accordance with the October 9 Determination, as clarified by the discussion above responding to Devon's December 8 Request. The restructured accounting must cover the period beginning when Devon began paying royalties to the Minerals Management Service on the coalbed methane produced from the Federal leases in each of the three fields to the present.

To comply with applicable regulations, Devon is ordered to perform the following steps within 60 days of receipt of this order.

- Restructure the accounting for the leases and wells for which Devon pays Federal royalties for coalbed methane sales from the Kitty, Spotted Horse, and Rough Draw Fields, Wyoming, starting with the sales months in which such payments were first made to the MMS and continuing to the present. The allowances must be restructured to reflect the valuation

determination dated October 9, 2003, as clarified by this letter and order.

- Report and pay any additional royalties shown to be due to, MMS based on the restructured accounting.

If Devon believes that 60 days, is not a sufficient time within which to perform the restructured accounting and report and pay, MMS may grant an extension of that time upon Devon's request and Devon's showing of what additional time is necessary and reasonable.

Hereafter, Devon must report and pay royalties under the regulations and guidelines discussed in this order. In the future, if Devon does not perform the required accounting or pay royalties in compliance with this order, we may treat the violations as willful. 30 C.F.R. Part 241, Subpart B (2003).

If Devon agrees with this order and voluntarily reports and pays to MMS, the modified Report of Sales and Royalty Remittance (Form MMS-2014) and payment must reach MMS within 60 days from the date Devon receives this order unless MMS grants an extension of that time. Devon must keep all documents supporting compliance with this order until MMS completes its follow-up compliance testing.

When reporting and paying, please:

- Use procedures outlined in 30 C.F.R. § 210.20 for electronic reporting of Form MM-2014. Chapter 9 of the Minerals

Revenue Reaorter Handbook-Oil, Gas, and Geothermal Resources (handbook) describes bow to report using electronic commerce.

- Use procedures outlined in 30 C.F.R. § 218.51(b) (2003) for electronic payments. Be sure to reference the Form MMS-2014 block 4 number in the electronic payment document.

- Use adjustment reason code 17 on Form MMS-2014. Place the number 72000100 in block 4.

- Call 800-525-0309 for assistance in reporting and payment.

After MMS receives payment, MMS will compute late-payment charges and bill Devon as required by 30 C.F.R. § 218.102 (2003).

If Devon does not comply with this order, we may assess civil penalties under section 109 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. § 1719, and 30 C.F.R. Part 241, Subpart B (2003), for failure to comply with statute, regulation, order, or terms of the lease.

Because this order is issued by an Assistant Secretary of the Department of the Interior, it is not subject to appeal to the Interior Board of Land Appeals and is the final action of the Department. *See Blue Star, Inc.*, 41 IBLA 337 (1979); *Marathon Oil Co.*, 108 IBLA 177 (1989). Further, because this order is issued by an Assistant Secretary, the provisions of 30 U.S.C. § 1724(d)(4)(B)(ii)(V)

regarding administrative appeal of the order do not apply.

For answers to questions, please call Mary Williams, Manager, Federal Onshore Oil and Gas Compliance, MMS at (303) 231-3403.

/s/

Chad Calvert
Acting Assistant Secretary
for Land and Minerals
Management

Enclosure: Acting Assistant Secretary's Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, Powder River Basin, Wyoming, dated October 9, 2003

APPENDIX D

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 07-5299 **September Term 2008**
04cv00821

Filed On: February 13, 2009

Devon Energy Corporation,
Appellant

v.

Kenneth Lee Salazar, Secretary of the Interior,
Appellee

BEFORE: Sentelle, Chief Judge, and Ginsburg,* Henderson, Rogers, Tatel, Garland, Brown, Griffith, and Kavanaugh, Circuit Judges, and Edwards and Silberman, Senior Circuit Judges

ORDER

Upon consideration of appellant's petition for rehearing en banc, and the absence of a request by any member of the court for a vote, it is

ORDERED that the petition be denied.

Per Curiam

FOR THE COURT:
Mark J. Langer, Clerk

BY: /s/
Michael C. McGrail
Deputy Clerk

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* Circuit Judge Ginsburg did not participate in this matter.

APPENDIX E

United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 25165
Denver, Colorado 80225-0165

Apr 22, 1996

Dear Operator/Payor:

The Minerals Management Service (MMS) has received many questions, primarily from producers in the vicinity of New Mexico's San Juan Basin, on how to report and pay royalties on coalbed methane. The following guidelines answer those questions.

These guidelines apply to coalbed methane produced from Federal and Indian leases. You must follow these guidelines to ensure proper payment of royalties and correct reporting of production. They apply specifically to circumstances where carbon dioxide (CO_2) is removed from produced coalbed methane and is vented without sale.

Valuing Production

Sales at the wellhead or CDP

If you sell your coalbed methane at the wellhead or a central delivery point (CDP) in the field or unit, you must value the coalbed methane as unprocessed gas under 30 CFR § 206.152 (1995).

For arm's-length sales, value for royalty purposes will be the gross proceeds you receive under your arm's-length contract. However, that value cannot be reduced, either directly or indirectly, for the costs

of placing coalbed methane in marketable condition. Placing production in marketable condition includes, but is not limited to, CO_2 removal (commonly called sweetening). Under 30 CFR § 206.152(i), if your sales price is reduced by fees for services to place production in marketable condition, either directly or indirectly, you must add that portion of the fees attributable to those services, including CO_2 removal, to your gross proceeds received from the sale of the coalbed methane to determine value for royalty purposes. If you pay a bundled fee for both CO_2 removal and transportation, we recognize that you may be unable to obtain the information necessary to segregate the CO_2-removal costs. If you are in this situation, contact the MMS' Valuation and Standards Division at 303-275-7240 for assistance in determining the portion of your service fees attributable to CO_2 removal.

For non-arm's-length sales, you must determine the value of the coalbed methane under the methods (benchmarks) described at 30 CFR § 206.152(c). Again, you cannot deduct costs of placing the coalbed methane in marketable condition. You must ensure that any value determined under the methods is not improperly adjusted for nonallowable costs.

For Indian leases, you must also meet the dual accounting and majority price requirement established by regulation and lease terms. However, for both Federal and Indian leases, under no circumstances can the value of the production for royalty purposes be less than the gross proceeds accruing to the lessee, less applicable allowances.

Sales at the CO_2-removal facility

If you sell your coalbed methane at the tailgate of a CO_2-removal or other treating facility, you must value it as unprocessed gas under 30 CFR § 206.152. For arm's-length sales, value will be your gross proceeds under the arm's-length contract. For non-arm's-length sales, you must determine the value of the coalbed methane under the benchmarks at 30 CFR § 206.152(c). You cannot deduct costs of removing the CO_2 or otherwise placing the coalbed methane in marketable condition. However, you can deduct costs of transportation as discussed below.

Determining Allowable Deductions From Value

Transportation allowances

You can take a transportation allowance for your reasonable, actual, and necessary costs of transporting the coalbed methane from the royalty measurement point (either the wellhead or the CDP) to the point of sale remote from the lease. You must use the regulation in 30 CFR § 206.156 and 206.157 (1995) and the instructions in Chapter 6 of the *Oil and Gas Payor Handbook, Volume III,* to calculate your transportation allowance.

In general, the regulations state that (1) you must allocate your transportation charges to all products produced and transported, and (2) you can only deduct the allocated costs from the value of products that are royalty bearing. For coalbed methane production, you can increase the transportation costs allocated to the methane component for the amount of CO_2 permitted in the main (inter- or intrastate) transmission line. For example, if your gas stream consists of 90 percent

methane and 10 percent CO_2 and the main transmission line allows 2 percent CO_2 in the makeup of its gas stream, you can include the costs of transporting the 2 percent CO_2 volume (or 92 percent of the total transportation cost) when calculating your allowance for methane.

You can include costs of dehydration occurring after metering at the royalty measurement point in your transportation allowance but you cannot deduct costs of dehydration occurring at the wellhead. You can include costs for compression occurring downstream of the royalty measurement point, to the extent the compression is necessary for transportation. This includes compression at the CDP and in the transportation system to the CO_2-removal facility. You cannot include those compression costs associated with production operations.

You must convert any payment for transportation that is made in-kind for dehydration and allowable compression to a dollar equivalent and include this amount in the transportation allowance deduction. You must allocate transportation costs for any allowable dehydration and compression (either in-value or in-kind) between the methane and CO_2 in the same manner as the in-value transportation cost.

You cannot include the costs of removing CO_2 as part of your transportation allowance. If you pay a bundled fee for both transportation and CO_2 removal and are unable to segregate the fee between these two services, the MMS' Valuation and Standards Division will help you determine the proper portion attributable to transportation.

Processing allowances

You cannot take a proceeding allowance for your costs of removing CO_2.

Other deductions

You cannot include any costs associated with moving the production from the wellhead to the CDP (gathering) when the Bureau of Land Management (BLM) has approved the CDP as the royalty measurement point.

You cannot include any costs associated with wellhead separation.

Reporting Production

For each lease or agreement producing coalbed methane, you must report the total volume of gas measured at the BLM-approved royalty measurement point on the Monthly Report of Operations (Form MMS-3160) as a Gas Transfer. Report the four-digit gas plant number and name of the plant receiving the largest volume of gas from the property (if gas is being transferred to more than one plant) in the Plant Number/Name field. If you are using additional plants for CO_2 removal,,,, identify the other plant(s) in the Comments section.

Report the Btu content of the gas, as determined at the royalty measurement point, on the API Gravity/Btu Content line. Report the percentage of CO_2 in the gas stream, as measured at the royalty measurement point, in the Comments section.

If you report gas as Used on or for Benefit of Lease, you must be consistent with the approvals of BLM. Do not include any gas used off-lease for

compression, dehydration, or CO_2 removal unless specifically approved by BLM.

Reporting Royalty

For each lease/revenue source combination, you must report the allocated share of the total volume of gas determined at the BLM-approved royalty measurement point in the Sales Quantity field on the Report of Sales and Royalty Remittance (Form MMS-2014). Report the gas as unprocessed gas (Product Code 04) using Transaction Code 01, Royalty Due. Report the Btu content of the gas, as determined at the royalty measurement point, in the Quality Measurement field.

Base the value reported in the Sales Value field on the criteria described in the Valuing Production section of this letter.

Report transportation allowances against Product Code 04 using Transaction Code 11.

If you have any questions about production or royalty reporting, contact the MMS Reports Branch at 800-525-0309 or 303-231-3288.

Sincerely,
/s/
Robert E. Brown

Acting Associate Director for Royalty Management

No. 08-1404

In the Supreme Court of the United States

DEVON ENERGY CORPORATION, PETITIONER

v.

KEN SALAZAR, SECRETARY OF THE INTERIOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the Administrative Procedure Act requires that an agency follow notice-and-comment procedures before interpreting its own regulations in an administrative adjudication where a prior interpretation of those regulations was made by officials who lacked authority to issue binding interpretations of the regulations on the agency's behalf.

2. Whether the Department of the Interior may order a natural-gas lessee to perform a restructured accounting and pay unpaid royalties due to the United States after the entity has partially paid those royalties to the United States.

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In the Supreme Court of the United States

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 551 F.3d 1030. The opinion of the district court (Pet. App. 25a-40a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on December 23, 2008. A petition for rehearing was denied on February 13, 2009 (Pet. App. 62a). The petition for a writ of certiorari was filed on May 14, 2009. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The United States owns lands that are rich with deposits of natural gas. The United States leases the right to extract and sell that gas to various entities, in-

cluding petitioner. In exchange, lessees agree to pay the United States royalties on the natural gas they produce.

Congress has established the framework for calculating natural gas royalties. Lessees must pay royalties of no less than 12.5% of the "amount or value of the production removed or sold from the lease." 30 U.S.C. 226(b)(1)(A). Department of the Interior (Interior) regulations specify that the "value of production" must be no less than the "gross proceeds" accruing to the lessee minus certain allowable deductions, 30 C.F.R. 206.152(h). Among other things, lessees may deduct from their "gross proceeds" the cost of transporting gas to a point away from the leased site, including to "a gas processing plant off the lease and from the plant to a point away from the plant." 30 C.F.R. 206.156(a).

Interior's regulations, however, specify that lessees must, "at no cost to the Federal Government," "place gas in marketable condition" for sale, *i.e.*, in a state in which the gas is "sufficiently free from impurities and otherwise in a condition that [it] will be accepted by a purchaser under a sales contract typical for the field or area." 30 C.F.R. 206.151, 206.152(i). The regulations therefore prohibit a deduction from "gross proceeds" for the costs incurred by the "lessee to place the gas in marketable condition." 30 C.F.R. 206.152(i).

2. Petitioner leases federal land in Wyoming that produces a type of natural gas known as coalbed methane. Pet. App. 5a. Natural gas produced under those leases is pumped to Central Delivery Points (CDPs)—*i.e.*, approved locations for measuring the royalties due—and it subsequently undergoes a complex series of compression, dehydration, and other processes before its sale. *Id.* at 6a-7a.

When calculating the royalties it owed the United States, petitioner deducted the compression and dehydration costs it incurred after the gas left CDPs, based on its view that those costs constituted transportation costs that may be deducted from gross proceeds. Pet. App. 8a. Petitioner contends that its interpretation was based primarily on two internal Minerals Management Service (MMS) guidance documents issued in late 1995 and a 1996 letter from the MMS Acting Associate Director for Royalty Management to royalty payors (Dear Operator letter). Cf. *id.* at 7a-8a.

3. a. In 2002, petitioner sought guidance from MMS to determine whether petitioner was properly deducting its post-CDP dehydration and compression costs as part of its transportation allowance. In 2003, the Acting Assistant Secretary of the Interior for Land and Minerals Management issued a decision concluding that petitioner's deductions were in error. Pet. App. 9a.

The initial agency decision explained that the costs of dehydration and certain compression processes after gas left the CDPs were not properly deductible "because th[ose] compression and dehydration functions were necessary to put the production into marketable condition." Pet. App. 9a. Petitioner's sales contracts required that petitioner "compress the gas to [the] pipeline pressure" of its purchaser's pipelines in order to allow the gas to flow into those lines and "enable the gas to be 'accepted by a purchaser under a sales contract typical for the field or area.'" *Ibid.* (quoting C.A. App. 88). Likewise, lessees were obligated to "dehydrate gas to the water content required for delivery to the pipeline" in order to sell gas under contracts typical for the field or area, and the Acting Assistant Secretary concluded that petitioner had failed to show that its rele-

vant dehydration processes were "for anything other than what is required to put the production into marketable condition" and "meet pipeline and purchaser requirements." *Id.* at 10a (quoting C.A. App. 91). The decision explained that petitioner had based its contrary interpretation of the relevant regulations on statements in internal MMS guidance documents and the Dear Operator letter that were "either ambiguous, or reflected an incorrect application of the marketable condition rule, or were simply 'inconsistent' with the rule." *Id.* at 9a (internal citations omitted).

In 2004, the Acting Assistant Secretary denied reconsideration in a final agency order that affirmed the initial agency decision in relevant part and directed petitioner to recalculate past royalties in accordance with the order. Pet. App. 10a.

b. Petitioner then filed the present action seeking judicial review of the agency's final decision. The district court entered summary judgment for respondent. Pet. App. 24a-40a.

c. The court of appeals affirmed. Pet. App. 1a-23a. The court concluded that Interior's 2004 "interpretation of [its] marketable condition rule" was controlling because it "reflects a perfectly reasonable construction" that is consistent with the "plain language of the rule." *Id.* at 3a, 12a-13a.

The court of appeals also concluded that it was not necessary for the agency to issue its 2004 interpretation of its royalty regulations through notice-and-comment rulemaking. Pet. App. 15a-23a. The court "agree[d] with [the government]" that the 1995 internal guidance documents and 1996 letter cited by petitioner did not constitute "official or binding [agency] action" and that, without a prior "definitive interpretation" by the agency,

the Administrative Procedure Act (APA), 5 U.S.C. 551 *et seq.*, "does not require notice and comment rulemaking to effect a change in that interpretation." Pet. App. 16a. The court provided two independent bases for that holding. *Id.* at 16a-23a.

First, the court found "much force to [the government's] argument that * * * the guidance documents were far from conclusive in what they said." Pet. App. 17a. That conclusion, the court explained, was reinforced by the fact that petitioner decided to seek formal confirmation from the agency of petitioner's regulatory interpretation—a request that itself undermined petitioner's contention that the agency documents "authoritatively resolved" the relevant questions. *Ibid.* ("It is perplexing, to say the least, that [petitioner] was seemingly confused over the propriety of its royalty accounting if, in its view, the matters at issue had been authoritatively resolved" by the guidance documents).

Second, the court held that "the [a]gency was free to adopt the interpretation at issue in this case without providing an opportunity for notice and comment" because the three guidance documents cited by petitioner did not "constitute[] authoritative and binding interpretations of the marketable condition rule" that expressed the agency's interpretation of its regulations. Pet. App. 17a, 23a. The court explained that the 1996 Dear Operator letter neither spoke for nor was "binding on the agency," *id.* at 18a, and the court found that conclusion to be supported by petitioner's admission that petitioner "does not contend that the * * * letter in and of itself was a binding rule," *id.* at 19a (quoting Pet. Corrected C.A. Reply Br. 14).

Petitioner instead argued that Interior had adopted a regulatory interpretation upon which petitioner relied

"through the cumulative effect of a number of agency actions." Pet. App. 19a (quoting Pet. Corrected C.A. Reply Br. 14). The court rejected that argument, concluding that the agency was bound neither by the fact that two internal guidance documents were issued in 1995 nor by the fact that regulated entities may have followed that guidance. *Id.* at 19a-21a. The court explained that petitioner "readily conceded" at oral argument that (a) the policy board that issued the internal guidance documents in 1995 lacked "authority to issue authoritative guidelines" and (b) the documents themselves "did not have the force of law." *Id.* at 19a. For those reasons, the internal guidance did not constitute "a definitive and binding statement on behalf of the agency." *Id.* at 20a. The court also rejected the view that Interior was "bound by the guidance documents" because "regulated parties followed the advice in the documents" for several years. *Ibid.* Such action by private entities, the court explained, did not transform otherwise non-binding guidance into agency documents with binding, "legal consequences." *Id.* at 21a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is unwarranted.

1. a. The informal rulemaking provisions of the APA specify that agencies must generally provide the public with notice of proposed rulemaking and an opportunity to comment on the proposal. 5 U.S.C. 553(b) and (c). Congress, however, exempted several categories of rules, including "interpretive rules," from the APA's notice-and-comment rulemaking requirements, 5 U.S.C. 553(b)(A), and separately specified that the Act's "rule

making" provisions do not apply to legal principles developed in agency adjudications. 5 U.S.C. 551(6) and (7).

The APA thus makes clear that Interior's regulatory interpretation in its final adjudicatory decision in this case is not subject to the APA's notice-and-comment rulemaking requirements. Indeed, even if the agency's adjudicatory decision could qualify as rulemaking, Section 553 specifically exempts "interpretive rules" from the Act's notice-and-comment requirements. That alone would justify the court of appeal's judgment. The APA, as this Court recently confirmed, "sets forth the full extent of judicial authority to review executive agency action for procedural correctness," and, because the statute does not specify that "all agency change be subjected to more searching review," there is no basis for courts to impose additional procedural hurdles for an agency to cross. *FCC* v. *Fox Television Stations, Inc.*, 129 S. Ct. 1800, 1810 (2009) (*Fox Television*) (citing *Vermont Yankee Nuclear Power Corp.* v. *NRDC*, 435 U.S. 519, 545-549 (1978)).

Although some courts of appeals concluded before *Fox Television* that an agency decision interpreting a regulation in a manner inconsistent with the agency's prior interpretation of that regulation must be issued using notice-and-comment procedures, Pet. 11-12, 14, the court of appeals correctly held that that court-imposed requirement for interpretive changes has no application here. Pet. App. 15a-23a. The court accepted petitioner's written and oral concessions that the informal guidance and letter proffered by petitioner as prior agency interpretations were authored by "individuals who had no authority * * * to issue authoritative guidelines on behalf of the agency." *Id.* at 3a, 19a. In the absence of a prior binding interpretation by the

agency itself, the court rejected the contention that notice-and-comment procedures were necessary before the agency interpreted its regulations in the first instance. *Id.* at 23a.

b. Petitioner contends (Pet. 9-19) that this Court should grant review to resolve a division of authority on whether notice-and-comment procedures must be used when an agency changes its prior interpretation of a regulation. Contrary to petitioner's contention, review is unwarranted.

First, although petitioner is correct that several courts of appeals have divided over whether such interpretative changes trigger notice-and-comment obligations (Pet. 11-12, 14), that question is not presented in this case. Indeed, the very proposition that petitioner embraces was first adopted by the District of Columbia Circuit in *Alaska Professional Hunters Ass'n* v. *FAA*, 177 F.3d 1030, 1033-1035 (D.C. Cir. 1999) (following dicta in *Paralyzed Veterans of Am.* v. *D.C. Arena L.P.*, 117 F.3d 579, 586 (D.C. Cir. 1997), cert. denied 523 U.S. 1003 (1998)), and the court of appeals in this case expressly held that the proposition it adopted in *Alaska Professional Hunters* was inapplicable because it applies only when an agency changes course from a prior binding interpretation by the agency. Pet. App. 22a-23a. The court of appeals concluded, based on petitioner's oral and written concessions, that there was no prior binding interpretation by the agency here.[1]

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[1] Petitioner does not discuss its concessions that the internal guidance documents and letter cited by petitioner were authored by officials with "no authority * * * to issue authoritative guidelines on behalf of the agency." Pet. App. 3a, 19a. Instead, petitioner now appears to assert (Pet. 3-4, 16 & n.6) that those officials did, in fact, have such authority, citing to materials never presented to the court of appeals. Peti-

Second, even if the question were presented in this case, review by this Court would be premature because the courts of appeals that have followed *Alaska Professional Hunters* have yet to determine whether the logic of their decisions remains viable after this Court's recent decision in *Fox Television*. *Fox Television* should now eliminate any doubt that courts cannot properly impose procedural requirements to govern an agency's change in position—like the judge-made rule imposed by *Alaska Professional Hunters*—where, as here, those requirements are not imposed by the APA itself.

c. Petitioner argues (Pet. 15-19) that the decision below conflicts with *Shell Offshore Inc.* v. *Babbitt*, 238 F.3d 622 (5th Cir. 2001), which concluded that notice-and-comment procedures were necessary where an agency adopted an unwritten but "long established and consistently followed practice" reflecting one interpretation of a regulation and later changed that interpretation. *Id.* at 630. Although the decision below is in tension with *Shell Offshore*, it does not conflict with that decision. *Shell Offshore* premised its decision on the existence of what it deemed to be a longstanding official practice of the agency reflecting an unwritten interpre-

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tioner's newly found contention comes too late. Not only did petitioner forfeit it by failing to raise it below, but petitioner affirmatively waived the argument by conceding the officials' lack of authority in the court of appeals. The court of appeals accepted that concession, Pet. App. 3a, 19a (discussing oral and written concessions), and no further review is warranted to consider that fact-bound determination. Cf. C.A. Pet. for Reh'g 2 (repeating concession that "[t]he regulatory interpretation that [petitioner] and others followed was not authored by an official authorized to promulgate rules binding on the agency"); cf. also Pet. 16 n.6 (attempting to distinguish prior decisions regarding similar Interior documents on the ground that the "parties in those cases" "presumably" did not raise the materials cited by petitioner for the first time at Pet. 3-4).

tation of agency regulations. The court in *Shell Offshore* did not decide whether it would reach the same result if that practice was based on decisions of subordinate officials who lack authority to issue a regulatory interpretation on the agency's behalf. Because that question was not raised or resolved in *Shell Offshore*, *Shell Offshore* does not conflict with the decision below.

d. This case would present a poor vehicle for resolving the first question presented for the additional reason that petitioner has not contested the court of appeals' conclusion that prior administrative interpretations of the regulations at issue do not appear to "conclusive[ly]" resolve the interpretive question disputed by the parties. Pet. 16a-17a; see also Gov't C.A. Br. 37-40 (explaining that the internal guidance and letter were ambiguous in this regard). Thus, even if the officials who issued the pertinent internal guideline documents and letter had authority to interpret the agency's regulations on the agency's behalf, Interior's final decision in this case did not trigger notice-and-comment obligations under *Alaska Professional Hunters* because it did not conflict with prior regulatory interpretations. See *MetWest Inc.* v. *Secretary of Labor*, 560 F.3d 506, 509-512 (D.C. Cir. 2009) ("[S]o long as a new guidance document 'can reasonably be interpreted' as consistent with prior documents, it does not significantly revise a previous authoritative interpretation.") (quoting *Air Transp. Ass'n* v. *FAA*, 291 F.3d 49, 57-58 (D.C. Cir. 2002)); see also *Darrell Andrews Trucking, Inc.* v. *Federal Motor Carrier Safety Admin.*, 296 F.3d 1120, 1126-1127 (D.C. Cir. 2002); *Shell Offshore*, 238 F.3d at 629 (stating that "the APA requires an agency to provide an opportunity for notice and comment before substantially altering a *well established* regulatory interpretation" (emphasis add-

ed)). Moreover, because the question whether the particular guidance documents at issue here were ambiguous has been overtaken by the agency's subsequent, authoritative interpretation of its regulations in this case, the question has no prospective importance and does not warrant this Court's review.

2. Petitioner argues (Pet. 19-23) that certiorari is warranted to determine whether Interior properly required petitioner "retroactively to recalculate royalties owed to the Government." Pet. 19 (emphasis omitted). Review is not warranted on that question. Petitioner did not challenge the retrospective impact of the agency's order in this case in its opening brief on appeal; the government's response explained that petitioner did "not argue that Interior may never require a royalty payor to recalculate the royalties it paid in past years" (Gov't C.A. Br. 44); and petitioner did not subsequently challenge the government's assertion. Indeed, petitioner's appellate briefs did not even cite the retroactivity decisions on which petitioner now relies (Pet. 20-22), and the court of appeals accordingly did not address any retroactivity-based contentions. Because the second question presented was not raised or passed upon below, further review is unwarranted.[2]

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[2] Although petitioner quotes (Pet. 19) from the court of appeals' statement that this case "arises from a final [agency] order * * * requiring [petitioner] retroactively to calculate royalties owed to the Government," Pet. App. 2a, that introductory statement before the court's legal analysis does not reflect a holding, and nothing in the opinion reflects a determination regarding the retrospective recalculation of royalties. In any event, Congress has expressly authorized Interior to order restructured accountings and collect underpaid royalties, 30 U.S.C. 1711(c)(1), 1724(d)(4)(B)(i), and that authorization undermines petitioner's apparent contention that such collection efforts are unlawful. See *BP Am. Prod. Co.* v. *Burton*, 549 U.S. 84, 87, 100-101 (2006).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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REPLY BRIEF FOR PETITIONER

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RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE (4th ed. Supp. 2009) 1

REPLY BRIEF FOR PETITIONER

The Government does not dispute that a well-developed conflict involving multiple circuits exists over the question whether a federal agency that has given its regulation a definitive interpretation must engage in notice-and-comment rulemaking before reversing that interpretation. The author of the leading administrative law treatise recently urged that this Court resolve "this difference of opinion with respect to an important question . . . ." RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE § 6.4, at 131 (4th ed. Supp. 2009).

This case also directly presents the issue identified but left open for resolution in *Smiley v. Citibank (S.D.), N.A.*, 517 U.S. 735 (1996) -- whether a federal agency that changes its interpretation of its own regulation may give retroactive effect to the new interpretation.

The Government's efforts to play down the circuit conflict and to suggest that this case is not suitable for resolving these indisputably important issues are unavailing.

1. The Government contends that the several courts of appeals that have explicitly adopted petitioner's position regarding the need for notice and comment rulemaking might not have done so in light of this Court's decision in *FCC v. Fox Television Stations, Inc.*, 129 S. Ct. 1800 (2009), *see* Opp. 9. Yet the Government elsewhere acknowledges that

the salient *Fox Television* holding simply reiterates the rule established by this Court more than thirty years ago in *Vermont Yankee Nuclear Power Corp. v. NRDC*, 435 U.S. 519 (1978), *see* Opp. 7.

The Government's related contention that *Fox Television* should be read to have resolved the dispute adversely to petitioner, *see* Opp. 9, is belied by the fact that two of the four current members of this Court who have previously endorsed petitioner's position (*see* Pet. 15) joined the *Fox Television* majority, and two the dissent. The first question presented is very much a live issue.

Indeed, *Fox Television* explicitly endorsed a core principle undergirding the petition: that an agency bears special responsibilities when it has "engendered serious reliance interests." 129 S. Ct. at 1811 (noting that an agency must "provide a more detailed justification . . . when its prior policy has engendered serious reliance interests that must be taken into account"); *see also id.* at 1823 ("Reliance interests in the prior policy may also have weight in the analysis") (Kennedy, J., concurring); *id.* at 1826 (referencing the "substantial interest [of regulated entities] in regulatory stability") (Stevens, J., dissenting).

Here, the regulatory interpretation upon which petitioner relied was one which it and all similarly situated gas producers were explicitly instructed that they were *required* to follow, *see, e.g.*, Pet. App. 63a ("Dear Payor" letter stating that lessees "*must follow these guidelines*" (emphasis added). The

agency repeatedly and emphatically reiterated the mandatory nature of its instructions, *see* Pet. 6 (citing *id.* at 63a–68a). The concerns implicated here are thus precisely those raised in *Fox Television*.

2. The Government's position that the decision below is merely in "tension" but not in "conflict" with *Shell Offshore Inc. v. Babbitt*, 238 F.3d 622 (5th Cir. 2001), *see* Opp. 9, does not withstand scrutiny. The Fifth Circuit held that a five-year period of MMS practice, even though unaccompanied by any written guidance from the agency, was sufficiently authoritative to warrant notice-and-comment procedures, without suggesting any requirement of approval by an individual with authority to bind the agency. *Shell*, 238 F.3d at 628–29 ("[T]he new 'rule' that Shell asserts violates the APA is not a change from a written policy statement or regulation. Rather, it is an alteration of an existing practice.") The D.C. Circuit, by contrast, held that a seven-year period of MMS practice, even when combined with written, mandatory pronouncements by agency officials, did not demand notice-and-comment procedures. (Pet. App. 17a–20a). The conflict could not be starker.

3. The explicitly compulsory effect the agency choose to give its regulatory interpretation -- a feature wholly ignored in the Government's opposition -- makes this case a particularly appropriate vehicle for resolving whether an agency may simply reverse a regulatory interpretation without satisfying any APA procedural safeguards.

While petitioner's claim below was argued based upon the longstanding and mandatory nature of the agency's interpretation, petitioner may also support its claim by the additional argument that the author of the mandatory instruction had been delegated the authority to bind the agency with respect to royalty calculation issues. *See Yee v. City of Escondido*, 503 U.S. 519, 534 (1992) ("Once a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below.").[1]

"[T]he issue [of the existence and scope of the delegation of authority to an agency official] is purely a legal one," *Air Brake Sys., Inc. v. Mineta*, 357 F.3d 632, 646 (6th Cir. 2004), and the delegation here appears on the face of the agency promulgations, extending to the MMS Associate Director for Royalty Management "the ability to make the final, binding decision" on issues relating to "the Secretary's authority to . . . ensure[ ] that the Government is paid timely and in full for . . . its contractual royalty

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1 Thus, the plaintiff in *Lebron v. National Railroad Passenger Corp.*, 513 U.S. 374, 378-79 (1995), was allowed to base his claim (that Amtrak had violated the First Amendment) on the argument that Amtrak should be considered an instrumentality of the federal government, although he had in the court below disavowed that position and contended that Amtrak had violated the First Amendment as a private entity.

shares . . .," *see* Pet. 4 & nn.1-2. The Government's opposition does not dispute this delegation, which it did not bring to the attention of the court of appeals in this case or in *Amoco Production Co.* v. *Watson*, 410 F.3d 722 (D.C. Cir. 2005), *aff'd on other grounds sub. nom. BP America Production Co.* v. *Burton*, 549 U.S. 84 (2006).

4. While the Government suggests that this case is an inappropriate vehicle due to uncertainty whether petitioner would have been permitted to deduct its dehydration and compression costs under the agency's prior, mandatory instructions (Opp. 10), the Government fails to quote or even describe the actual language used by the agency in the "Dear Payor" letter:

> You can include costs of dehydration occurring after metering at the royalty measurement point in your transportation allowance but you cannot deduct costs of dehydration occurring at the wellhead. You can include costs for compression occurring downstream of the royalty measurement point, to the extent the compression is necessary for transportation. This includes compression at the CDP [central delivery point] and in the transportation system to the CO_2-removal facility. You cannot include those compression costs associated with production operations. (Pet. App. 66a).

There is no ambiguity here. The court of appeals certainly never held that petitioner could not deduct its compression and dehydration costs under the mandatory instructions. The theoretical possibility of such a holding on remand is extremely remote given the language quoted *supra*.[2]

5. The Government leaves almost untouched petitioner's arguments why review is also warranted to resolve whether a federal agency can retroactively impose additional financial obligations for the period prior to its new regulatory interpretation, when its contrary, mandatory instructions were still in force. Such conduct by the Government with respect to federal oil and gas leases goes to the heart of this Court's repeatedly-expressed concerns over the retroactive application of government requirements affecting "contractual [and] property rights [for] which predictability and stability are of prime

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[2] The notion that petitioner's having sought a determination of the propriety of its overall royalty obligation calculations itself suggests a lack of clarity in the mandatory instructions (Opp. 5) ignores that (a) the State of Wyoming was challenging petitioner's right to deduct *any* transportation costs incurred before the gas had been placed into marketable condition, *see, e.g.*, AR 87 (State averment that "a transportation allowance is not permitted for gas that is not in marketable condition"), and (b) the determination sought involved numerous unrelated issues including the valuation of gas sales, the treatment of transportation costs paid to related affiliates, and a request for an exception to certain reporting requirements, *see* C.A. App. 166-70.

importance." *Landgraf v. USI Film Prods.*, 511 U.S. 244, 271 (1994).

Recent decisions by this Court have reiterated these apprehensions regarding retroactivity. *E.g.*, *AT & T Corp. v. Hulteen*, 129 S. Ct. 1962, 1971 (2009) ("a presumption against retroactivity will generally coincide with legislative and public expectations. Requiring clear intent assures that Congress itself has affirmatively considered the potential unfairness of retroactive application and determined that it is an acceptable price to pay for the countervailing benefits" (quoting *Landgraf* 511 U.S. at 272-73); *Republic of Iraq v. Beaty*, 129 S. Ct. 2183, 2194 (2009) (noting "the judicial presumption against retroactivity").

6. Rather than addressing the importance of the retroactivity issue or the implications of *Landgraf* and the numerous other decisions cited by petitioner, the Government contends that "[p]etitioner did not challenge the retroactive impact of the agency's order in this case in its opening brief on appeal." (Opp. 11). This is simply not so.

The very first item listed under the heading "Statement of Issues Presented for Review" in petitioner's opening brief on appeal (at 2) was:

> Whether Interior can lawfully require Devon to recalculate its federal natural gas royalties *retroactively* using a new royalty valuation methodology that is inconsistent with . . . the methodology

> Devon and all other federal royalty payors were instructed to use at the time the royalty payments were made. (emphasis added).

Devon advanced this anti-retroactivity claim repeatedly in its opening and reply briefs:

> "Devon followed Interior's publicly-announced guidelines and instructions when it deducted its post-CDP dehydration and compression costs. Now, Interior says it can repudiate those guidelines and explicit instructions and require Devon to recalculate its royalties *retroactively* using Interior's new interpretation of its regulations. Interior is incorrect. Devon's reliance interest is protected by the APA." (Opening Br. 16) (emphasis added).

> "The decision is also arbitrary and capricious because . . . Devon has been required to comply with [the agency's new regulatory interpretation of marketable condition] *retroactively*." (Opening Br. 19) (emphasis added).

> "Devon has been required to *retroactively* recalculate its royalties using the new interpretation. . . ." (Opening Br. 47) (emphasis added).

> "Not only does Section 553 of the APA prohibit such a *retroactive* change in the agency's authoritatively-adopted valuation instructions, but this type of *retroactive* agency about-face is also arbitrary and capricious under Section 706 of the APA and Interior's own precedents." (Reply Brief 19 n.9) (emphasis added).

Petitioner thus explicitly and repeatedly advanced its retroactivity claim. To the extent the Government is merely contending that additional arguments in support of the retroactivity claim are set forth in the petition, again, that is clearly appropriate, *see* p. 4 *supra* and *Yee*, 503 U.S. at 534 ("Once a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below."); *see also PGA Tour, Inc. v. Martin*, 532 U.S. 661, 678 n.27 (2001).[3]

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[3] While the Government is of course entitled to audit a lessee's royalty payments and collect any underpayments relating to past production, *see* Opp. 11 n.2 (citing 30 U.S.C. §§ 1711(c)(1), 1724(d)(4)(B)(i)), these statutory provisions nowhere authorize Interior to give retroactive effect to a new interpretation of a lessee's royalty obligations. The "restructured accounting" referenced in § 1724(d)(4) is simply a required accounting of royalty obligations in order to correct for

(...continued)

7. Resolution of the issues presented is of substantial prospective importance, *cf.* Opp. 11. With respect to the specific governmental conduct at issue, the agency still has not engaged in the required notice and comment rulemaking, and the purported obligation of petitioner and other lessees to make retroactive payments covering the period before the Government changed its mandatory instructions is also still unresolved.

More generally, what procedural obligations are incumbent upon the Government before changing its regulatory interpretations is a recurring issue, and the disparate answers provided to date by the courts of appeals ensures that uncertainty and conflicting results will persist absent resolution by this Court.

Likewise, the "predictability and stability" that this Court has deemed of "prime importance"

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any "repeated, systemic reporting errors" in a lessee's original accounting, *see* § 1724(d)(4)(B)(i).

BP America Production Co. v. Burton, 549 U.S. 84 (2006), also cited at Opp. 11 n.2, addressed whether the six-year statute of limitations for government contract actions applies to administrative orders assessing royalty underpayments, a question having no bearing on any issue presented here.

(*Landgraf, supra*) will continue to be undercut absent clarification of the limitations against the establishment of retroactive obligations, particularly those which (as here) involve contractual and property rights.

CONCLUSION

The petition for a writ of certiorari should be granted.

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Supreme Court of the United States

DEVON ENERGY CORPORATION,
Petitioner,

v.

KENNETH L. SALAZAR,
SECRETARY OF THE INTERIOR,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF OF AMERICAN PETROLEUM INSTITUTE AS *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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I. INTEREST OF AMICUS CURIAE

The American Petroleum Institute ("API") is the primary trade association of the oil and gas industry. API's more than 400 members conduct much of the production, refining, marketing and transportation of petroleum and petroleum products in the United States. Together with its member companies, API is committed to ensuring a strong, viable U.S. oil and natural gas industry capable of meeting the energy needs of our nation in an efficient and environmentally responsible manner.

API submits this amicus brief in support of the Petition for a Writ of Certiorari of Petitioner Devon Energy Corporation ("Devon").[1] API submits this brief to address a matter that is critical to its members and to all federal oil and gas lessees: to-wit, the unlawful decision by the Department of the Interior ("Interior") retroactively to reverse, without any opportunity for notice and comment, the agency's established regulatory interpretation concerning the valuation of gas produced from federal lands.

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[1] Pursuant to Supreme Court Rule 37.6, amicus curiae certifies that no counsel for a party authored this brief in whole or in part, and that no person or party, other than amicus curiae, its members, or its counsel made a monetary contribution to the preparation or submission of this brief. Although Devon is a member of API, Devon has not made any financial contribution to cover the costs incurred by API in preparing this amicus brief. Counsel of record for all parties have consented to the filing of this brief, and letters of consent have been filed with the Clerk.

API's members and hundreds of other non-member companies and individuals own oil and gas leases administered by Interior that cover billions of acres of onshore and offshore federal lands. Federal lessees pay billions of dollars in royalties to Interior each year through monthly royalty payments based on the "value of production saved, removed, or sold" from leased lands, as determined by Interior's regulations. In connection with these payments, federal lessees must file monthly reports with Interior containing thousands of lines of data regarding the location, volumes, and values of production. API's members and all other federal lessees take great care in preparing these payments and reports, as non-compliance can expose a lessee not only to a claim for underpaid royalties and interest, but potentially to penalties as well.

Given the legal consequences, detailed regulatory reporting burden, and financial impact of Interior's royalty valuation system, the reliability and predictability of that system are critical for all federal lessees, including API's members. Although Interior's regulations are detailed, they do not address every important issue. Accordingly, when Interior announces an interpretation of its regulations, and instructs lessees that they must follow that interpretation, it is essential for federal lessees to be able to rely on such direction. Interior's regulatory interpretations are of significant importance to API's members and all federal lessees in making financial planning and investment decisions. It is especially important that API's members and all other federal lessees, having performed in reliance on Interior's well-established

regulatory interpretation, not be required retroactively to recalculate the value of production, pay additional royalties and interest, and revise the voluminous data contained in their previously-filed reports, simply because Interior has changed its mind. Given the interest of API's members in the predictability and certainty of their royalty payment and reporting obligations, API's members are vitally interested when Interior seeks retroactively to repudiate a consistently-applied interpretation of its valuation regulations.

II. SUMMARY OF ARGUMENT

API agrees with Petitioner Devon that this Court should grant a writ of certiorari on the questions presented in the Petition. API submits this brief to highlight additional reasons why review of this case is appropriate and necessary. This Court should grant the Petition to resolve conclusively the following issue of administrative law that – given the circuit split on the issue – is badly in need of this Court's authoritative voice: Whether an agency must engage in rulemaking and must abide by the notice and comment procedures of the Administrative Procedure Act ("APA") when the agency fundamentally alters the agency's definitive and consistently-applied initial interpretation of its regulations. This Court should additionally grant the Petition to find that an agency may not give retroactive effect to its new, contrary interpretation of its regulations.

This case concerns Interior's unlawful departure from an authoritatively-established

interpretation of its regulations that govern a federal lessee's duty to pay royalties on natural gas. After eight years of instructing federal lessees regarding the proper deduction of dehydration and compression costs from the royalty value of natural gas, Interior simply changed its mind and ruled that Devon could not deduct such costs. API respectfully urges the Court to grant a writ of certiorari to clarify that an agency's 180-degree deviation from its established regulatory interpretation violates Section 553 of the APA. 5 U.S.C. § 553.

A grant of certiorari here will provide guidance to the lower federal circuit courts, which are split as to whether an agency's reversal of its long-standing regulatory interpretation violates the "notice and comment" rulemaking requirements of Section 553. The decision below, *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008),[2] is erroneous in concluding that Interior did not need to follow the notice and comment requirements of Section 553 of the APA when it departed from its longstanding interpretation of its valuation regulations. The decision below conflicts with – at the very least – the opinion of the United States Court of Appeals for the Fifth Circuit in *Shell Offshore, Inc. v. Babbitt*, 238 F.3d 622, 629 (5th Cir. 2001). API respectfully submits that the Fifth Circuit is correct and that, when a federal agency has adopted a definitive interpretation of a regulation, "the APA requires an agency to provide an opportunity for notice and comment before

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[2] The opinion is attached as Exhibit A to the Devon Petition.

substantially altering a well established regulatory interpretation." *Id.* Interior has never denied that it deviated from its consistently-applied interpretation that allowed the deduction of dehydration and compression costs; instead, Interior has argued in the courts below that its original regulatory interpretation was an "unauthorized" "interpretive error" contained within "internal memoranda between subordinate agency officials." However, the record and a series of Interior rulings plainly demonstrate otherwise. Accordingly, this Court should grant the Petition for a Writ of Certiorari to determine that Interior unlawfully failed to follow the notice and comment rulemaking procedures mandated by Section 553.

Even aside from Section 553, Interior's retroactive alteration of its regulatory interpretation was "arbitrary and capricious" under Section 706 of the APA and violative of this Court's precedent. 5 U.S.C. § 706. This Court, the lower federal courts, and Interior itself have frequently held that an agency's retroactive departure from an established agency position violates Congress's prohibition against "arbitrary and capricious" agency conduct. For this reason alone, more fully articulated below, this Court should grant the Petition for a Writ of Certiorari.

Indeed, if the erroneous decision below is allowed to stand, the national impact is enormous. Federal onshore and offshore lessees could now be required to recalculate years of royalty and interest payments at the whim of an agency official's re-interpretation of the royalty valuation regulations.

That result would disregard the federal lessees' reliance interests and reasonable expectations that, by following explicit agency guidance, the royalty payments that they had been making for eight years were correct. If the Court does not correct the decision below, Interior may now require those lessees to expend the time, money, and manpower to recalculate those payments and remit to Interior additional royalties and interest in degradation of prior instructions on which API's members relied. In sum, the split in the lower federal circuit courts, the improper retroactive application of Interior's re-interpretation of its royalty valuation regulations, and the national impact that the erroneous decision below will have if allowed to stand all warrant review by this Court.

III. ARGUMENT

1. Interior's Departure From Its Established Regulatory Interpretation Violated The Notice And Comment Requirements Of Section 553 Of The APA And Warrants Review By This Court.

In both the 1995 Minerals Management Service ("MMS") "Guidance" documents and the 1996 "Dear Operator/Payor" letter, Interior expressly stated that costs of dehydration and compression incurred after gas passed through the royalty measurement point were "transportation costs" that could be deducted from the value on which federal lessees pay royalty. (Petition for a Writ of Certiorari

("Devon Petition") at pp. 5-6.) The 1996 letter left no doubt as to MMS's expectations from industry:

> You must follow these guidelines to ensure proper payment of royalties and correct reporting of production.

(Petition Appendix ("Pet. App.") at 63a.)[3] From 1995 until 2003, Interior consistently interpreted its valuation regulations in the manner articulated in these three documents – *i.e.*, to permit the deduction of dehydration and compression costs as part of a lessee's transportation allowance. This interpretation was consistent with earlier Interior determinations that, under certain circumstances, dehydration and compression could be deductible "transportation" costs. *E.g.*, *Shell Offshore Inc.*, 142 IBLA 71 (1997) (compression deductible); *Exxon Corp.*, 118 IBLA 221, 244 (1991) (dehydration deductible).

In accordance with Interior's administrative decisions and the 1995 and 1996 MMS documents, federal lessees relied on Interior's regulatory interpretation in making millions of dollars of royalty payments, filing innumerable lines of data in their monthly royalty reports, and planning their business operations. As a result, Interior's decisions in 2003 and 2004 *disallowing* Devon's request to deduct the very costs that Interior had consistently

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[3] The letter is attached as Appendix E to the Devon Petition.

allowed turned the world upside down for the regulated community. The APA does not permit this.

As grounds for its complete turnaround on the deductibility of dehydration and compression costs, Interior has argued in the lower courts that its original interpretation was an "unauthorized" "interpretive error" contained within "internal memoranda between subordinate agency officials." Thus, cloaking itself with the assertion that it got the law wrong, Interior seeks to undermine nearly a decade of payments, reporting, and financial planning by federal lessees who relied on the agency's express interpretation.

Devon has effectively briefed to this Court the circuit split that exists in this area of administrative law, and API will not repeat that argument. (Devon Petition at pp. 9-19.) API does emphasize that this Court should grant the Petition to resolve this conflict among the circuit courts because resolution of this issue is critically necessary for federal onshore and offshore lessees. Indeed, resolution by this Court is of the utmost importance as federal lessees cannot be subjected to one standard of administrative law in three circuits and another standard in two other circuits. *Id.*; *Compare SBC Inc. v. FCC*, 414 F.3d 486, 498 (3d Cir. 2005) (requiring that agency comply with notice and comment requirements of the APA "if an agency's present interpretation of a regulation is a fundamental modification of a previous interpretation"), *Dismas Charities, Inc. v. DOJ*, 401 F.3d 666, 682 (6th Cir. 2005) (same), *and Shell*

Offshore, Inc. v. Babbitt, 238 F.3d 622, 629 (5th Cir. 2001) (same), *with Erringer v. Thompson*, 371 F.3d 625, 632 (9th Cir. 2004) (compliance with notice and comment not required), *and Warder v. Shalala*, 149 F.3d 73, 81-82 (1st Cir. 1998) (same).

As the Devon Petition makes clear, the strongest split in the lower federal circuits exists between the opinion below, *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008), and the Fifth Circuit's opinion in *Shell Offshore, Inc. v. Babbitt*, which both addressed MMS's change in its established interpretation of its royalty valuation regulations. Indeed, as in Devon's case here, *Shell Offshore* involved MMS's repudiation of its established interpretation of its royalty valuation regulations pertaining to the deduction of transportation costs. 238 F.3d at 624-26. This circuit split in and of itself merits this Court's review of this important question of federal administrative law. *See* Sup. Ct. R. 10(a) (noting that the Court will consider review when "a United States court of appeals has entered a decision in conflict with the decision of another United States court of appeals on the same important matter").

Moreover, the District of Columbia Circuit's decision below conflicts with two earlier opinions from the same circuit and the underlying reasoning in those opinions. *See Alaska Prof'l Hunters Ass'n v. FAA*, 177 F.3d 1030, 1033-35 (D.C. Cir. 1999); *Paralyzed Veterans v. D.C. Arena L.P.*, 117 F.3d 579, 586 (D.C. Cir. 1997). ("Once an agency gives its regulation an interpretation, it can only change that interpretation as it would formally modify the

regulation itself: through the process of notice and comment rulemaking.") Accordingly, not only are federal lessees subject to two conflicting standards of administrative law at the national level, but they are subject to two conflicting standards within the jurisdiction of the District of Columbia Circuit as well.

This Court needs to provide authoritative guidance to the lower federal courts that Section 553 of the APA guarantees Interior's lessees, including Devon and API's members, the right to perform their royalty payment and reporting obligations based on Interior's established regulatory interpretation until the agency changes that interpretation through formal rulemaking procedures. Rather than comply with these APA requirements when it made its 180-degree change in how to value coalbed methane, Interior ignored the APA and made that change unilaterally and retroactively. This precise type of agency conduct – changing the rules in the middle of the game without allowing the input of the regulated community – was held to violate APA rulemaking requirements in *Shell Offshore Inc.*, *Alaska Professional Hunters*, and *Torch Operating Co. v. Babbitt*, 172 F. Supp. 2d 113, 124-25 (D.D.C. 2001). For these reasons, API respectfully asks this Court to grant the Petition for a Writ of Certiorari to resolve the split in the circuit courts and hold that Interior must engage in the notice and comment rulemaking procedures of Section 553 of the APA when it departs from a longstanding interpretation of its valuation regulations.

2. Review By This Court Is Further Warranted Because It Is Arbitrary And Capricious For Interior To Apply Its Changed Regulatory Interpretation Retroactively.

This Court should also grant the Petition for a Writ of Certiorari to conclude that Interior may not apply its new and contrary interpretation of its valuation regulations retroactively. If Interior's decision is upheld, the retroactive reach of Interior's decision could extend not only to Devon, but also to API's member companies. Interior may rely on that decision to require some of API's members to recalculate years of prior monthly royalty payments and pay millions of dollars that, through the Guidance Documents and the Dear Operator letter, Interior had expressly assured API's members were not due. The prohibition against "arbitrary and capricious" agency action in Section 706 of the APA precludes Interior from such retroactive conduct. 5 U.S.C. § 706.

Limitations on the authority of federal agencies to act retroactively are commonly recognized by this Court and the lower federal courts. *E.g.*, *Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204 (1988) (holding that federal agency may not promulgate rules with retroactive effect unless Congress explicitly grants such authority); *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972) (holding that "rule" announced in the course of adjudication can not be applied retroactively without first balancing equitable factors). This prohibition against

retroactivity applies equally to Interior. Indeed, more than fifty years ago, the Ninth Circuit ruled that, because Interior's authority to determine the value of gas for royalty purposes was so extraordinary, Interior could apply a new valuation methodology prospectively only. *Cont'l Oil Co. v. United States*, 184 F.2d 802, 820-21 (9th Cir. 1950). *Cf. S&G Excavating, Inc. v. United States*, 15 Cl. Ct. 157 (1988) (refusing to allow Office of Surface Mining to apply new regulatory interpretation retroactively). Because the D.C. Circuit's decision conflicts with this Court's precedents regarding retroactive agency conduct, review is warranted. *See* Sup. Ct. R. 10(c) (noting that this Court will consider review when "a United States court of appeals . . . has decided an important federal question in a way that conflicts with relevant decisions of this Court").

Interior itself has frequently ruled that it is impermissible retroactively to change the value of oil or gas to the detriment of a federal or Indian lessee. For example, in *Sun Exploration & Production Co.*, 112 IBLA 373 (1990), a federal lessee had used a sliding-scale methodology to value crude oil, which methodology had been applied regularly by Interior during and after the relevant audit period. When MMS then ordered the lessee to recalculate past royalty payments based on a different valuation methodology, Interior's Board of Land Appeals ("IBLA") rejected MMS's retroactive application of this different valuation methodology: "When MMS departs from a prior administrative position and seeks to apply its new position retroactively, it is not enough to state that it has the right to do so." *Id.* at 387.

After the IBLA ruled in *Sun Exploration* that a lessee could not be required to recalculate past royalty payments based on a valuation methodology that was different than the methodology that had been approved contemporaneously with making the royalty payments, MMS acknowledged its obligation to respect industry's reliance on established agency practices:

> After further consideration of IBLA's decision, the Department has determined that it should continue to interpret gross production in a manner consistent with the well-established practice that lessees have historically relied on.

56 Fed. Reg. 63, 661 (1991).

API cannot overemphasize the importance to its members of upholding these recognized restrictions on Interior's authority. Because Interior writes the royalty valuation regulations, because those regulations cannot provide detailed instruction for every factual situation, and because industry's frequent use of new technologies to find, produce, and transport hydrocarbons often creates questions of regulatory interpretation, federal onshore and offshore lessees *must* be able to rely on Interior's consistently-followed regulatory interpretations. If this Court does not grant certiorari to reverse Interior's newly-found retroactive prohibition

against deducting dehydration and compression costs, some of API's members will likely be required to recalculate years of prior monthly royalty payments that complied with Interior's express regulatory interpretation at the time the royalties were originally calculated, simply because Interior changed its mind. The APA protects API's members against such "arbitrary and capricious" agency conduct. *See Atchison, Topeka & Santa Fe R.R. Co. v. Wichita Bd. of Trade*, 412 U.S. 800, 807 (1973) (holding that agency faces difficult burden when it attempts to depart from its "settled course of behavior"); *Acadian Gas Pipeline Sys. v. FERC*, 878 F.2d 865, 870 (5th Cir. 1989) (vacating agency decision because agency, "without a sufficiently articulated justification, impermissibly deviated from past practice"); *Cotton Petroleum Corp. v. DOI*, 870 F.2d 1515, 1526 (10th Cir. 1989) (reversing Interior decision due to Interior's failure to articulate a reasoned explanation for failing to follow established practices and because, "[w]here it is shown that an administrative agency deviated from its established procedures, the presumption of administrative regularity does not apply"). Accordingly, this Court should grant the Petition for a Writ of Certiorari to find that Interior may not apply its new and contrary regulatory interpretation retroactively.

3. A Federal Oil And Gas Lessee's Exposure To Penalties Underscores The Importance Of This Issue Of Federal Law.

A federal lessee must especially be able to rely on Interior's interpretation of its royalty regulations due to a lessee's exposure to penalties under the Federal Oil and Gas Royalty Management Act, 30 U.S.C. §§ 1701, 1719 ("FOGRMA"), as well as a lessee's potential liability under the False Claims Act, 31 U.S.C. §§ 3701 *et seq.* ("FCA"). Under FOGRMA, royalty underpayments "are by definition improper" and may, under some circumstances, subject the payor to civil and/or criminal penalties. *Forest Oil Corp.*, 116 IBLA 176, 182 (1990). Under the FCA, a lessee may be liable if it "knowingly makes, uses, or causes to be made or used, a false record or statement to conceal, avoid, or decrease an obligation to pay or transmit money or property to the Government." 31 U.S.C. § 3729(a)(7). API's members and other industry representatives are frequent targets of FCA relators, a situation that is only exacerbated by uncertainties affecting a lessee's royalty reporting and payment obligations. *See, e.g.*, *In re Natural Gas Royalties Qui Tam Litigation*, 562 F.3d 1032 (10th Cir. 2009); *Maxwell v. Kerr-McGee Oil & Gas Corp.*, 540 F.3d 1180 (10th Cir. 2008). Given this potential exposure above and beyond the royalty payments themselves, it is essential that a federal lessee be able to rely on Interior's established regulatory interpretation.

IV. CONCLUSION

Federal lessees must be able to rely on Interior's expressly-stated and consistently-followed regulatory interpretation. Here, Interior adopted an express interpretation, consistent with numerous other agency decisions, that authorized the deduction of compression and dehydration costs as part of a federal lessee's transportation allowance, and communicated that regulatory interpretation to federal lessees. After publishing its regulatory interpretation to industry, Interior applied that interpretation for eight years. Interior then performed an about-face and ordered the retroactive application of a new and contrary regulatory interpretation.

This Court should grant the Petition for a Writ of Certiorari, ultimately to conclude that Interior's retroactive reversal of its interpretation violates the rulemaking requirements of Section 553 of the APA and Section 706's prohibition against arbitrary and capricious agency conduct. For these reasons, and the reasons set forth by Devon in its Petition for a Writ of Certiorari, API respectfully asks this Court to grant the Petition for a Writ of Certiorari.

Respectfully submitted,

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